



STATE OF CALIFORNIA

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November 9, 2006

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State Controller, Sacramento

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Executive Director

Dear Interested Party:

Enclosed are the Agenda, Issue Paper, and Revenue Estimate for the November 20, 2006 Business Taxes Committee meeting. This meeting will address proposed Regulation 1671.1, *Discounts, Coupons, Rebates, and Other Incentives*.

Action 1 on the Agenda consists of the Business Taxes Committee's approval and authorization to publish either Alternative 1, staff's version of proposed Regulation 1671.1, or Alternative 2, Industry's version of proposed Regulation 1671.1.

If you are interested in other topics to be considered by the Business Taxes Committee, you may refer to the "Business Taxes Committee" page on the Board's Internet web site (<http://www.boe.ca.gov/meetings/btcommittee.htm>) for copies of Committee discussion or issue papers, minutes, a procedures manual, and a materials preparation and review schedule arranged according to subject matter and meeting date.

Thank you for your input on these issues and I look forward to seeing you at the Business Taxes Committee meeting at **9:30 a.m.** on **November 20, 2006** in Room 121 at the address shown above.

Sincerely,

Randie L. Henry, Deputy Director
Sales and Use Tax Department

RLH: lrc

Enclosures

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cc: (all with enclosures)

Honorable John Chiang, Chair
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Ms. Betty T. Yee, Acting Member, First District (MIC 71)
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Honorable Steve Westly, State Controller, C/O Ms. Marcy Jo Mandel (MIC 73)
Mr. Chris Schutz, Board Member's Office, Fourth District (MIC 72)
Mr. Neil Shah, Board Member's Office, Third District (via e-mail)
Mr. Romeo Vinzon, Member's Office, Third District (via e-mail)
Mr. Alan LoFaso, Board Member's Office, First District (via e-mail)
Mr. Steve Kamp, Board Member's Office, First District (MIC 71 and via e-mail)
Ms. Mira Tonis, Board Member's Office, First District (via e-mail)
Ms. Margaret Pennington, Board Member's Office, Second District (via e-mail)
Mr. Lee Williams, Board Member's Office, Second District (MIC 78 and via e-mail)
Mr. Ramon J. Hirsig (MIC 73)
Ms. Kristine Cazadd (MIC 83)
Mr. Robert Lambert (MIC 82)
Mr. Randy Ferris (MIC 82)
Ms. Janice Thurston (via e-mail)
Ms. Jean Ogrod (via e-mail)
Mr. Jeff Vest (via e-mail)
Mr. David Levine (MIC 85)
Mr. Steve Ryan (MIC 85)
Mr. Rey Obligacion (via e-mail)
Mr. Todd Gilman (MIC 70)
Mr. Kenneth Topper (via e-mail)
Mr. Dave Hayes (MIC 67)
Ms. Freda Orendt (via e-mail)
Mr. Stephen Rudd (via e-mail)
Mr. Joseph Young (via e-mail)
Mr. Jeffrey L. McGuire (MIC 92 and via e-mail)
Mr. Vic Anderson (MIC 44 and via e-mail)
Mr. Geoffrey E. Lyle (MIC 50)
Ms. Leila Khabbaz (MIC 50)
Ms. Lynda Cardwell (MIC 50)
Mr. Chuck Arana (MIC 50)

AGENDA —November 20, 2006, Business Taxes Committee Meeting
Proposed Regulation 1671.1, Discounts, Coupons, Rebates, and Other Incentives

<p>Action 1 — Proposed New Regulation 1671.1</p> <p>Issue Paper Alternative 1</p>	<p>Approve and authorize publication of either:</p> <p>Staff’s version of proposed new Regulation 1671.1 to provide:</p> <p>(1) Clarification on the application of tax to a broad array of noncontroversial coupon, manufacturer’s rebate, and discount issues, as agreed to by staff and interested parties.</p> <p>(2) Operative October 1, 2007:</p> <ul style="list-style-type: none"> • Define third party to mean, as proposed by Industry, a person other than the retailer or the retailer’s customer, such as a manufacturer or retailer’s vendor. • A presumption that rebate revenues received from a third party are taxable unless the retailer provides written evidence that the revenues received are not based on a required price reduction on a transaction-by-transaction basis, in exchange for a like amount from a third party. • A requirement that retailers must disclose to the customer the amount of any rebate revenue upon which “tax” is collected. <p style="text-align: center;">OR</p>
<p>Issue Paper Alternative 2</p>	<p>Industry’s version of proposed new Regulation 1671.1 to provide:</p> <p>(1) Clarification on the application of tax to a broad array of noncontroversial coupon, manufacturer’s rebate, and discount issues, as agreed to by staff and interested parties.</p> <p>(2) Rebate revenues are taxable when:</p> <ul style="list-style-type: none"> • The rebate program is between the retailer and a third party, as defined above. • Receipt of the rebate is conditioned upon a specified reduction in the retailer’s selling price of particular products. • The customer has direct knowledge, through documentation, of the payment by the third party to reimburse the retailer for the reduction in selling price.

AGENDA — November 20, 2006, Business Taxes Committee Meeting
Proposed New Regulation 1671.1, Discounts, Coupons, Rebates, and Other Incentives

Action Item	Regulatory Language Proposed by Staff	Regulatory Language Proposed by Industry
<p>Action 1 -</p> <p>Proposed Regulation 1671.1</p>	<p>(a) IN GENERAL. Retailers often engage in marketing and sales programs in which they issue coupons or other indicia to their customers that entitle the customers to a reduction in the amount they are required to pay for products sold by the retailers. Manufacturers, vendors, and other third parties often engage in various programs that result in credits or payments made to retailers with respect to a retailer's taxable sale of products to an end-use customer. These payments and credits include, but are not limited to, purchase and cash discounts, coupon reimbursements, ad or rack allowances, buy-downs, scanbacks, voluntary price reductions and other incentives, promotions, and rebates. Under certain conditions, payments received by the retailer in the form of rebates or other types of payments or credits for products sold at retail are included in the retailer's gross receipts or sales price from the sale of the product.</p>	<p>(a) IN GENERAL. Retailers often engage in marketing and sales programs in which they issue coupons or other indicia to their customers that entitle the customers to a reduction in the amount they are required to pay for products sold by the retailers. Manufacturers, vendors, and other third parties often engage in various programs that result in credits or payments made to retailers with respect to a retailer's taxable sale of products to an end-use customer. These payments and credits include, but are not limited to, purchase and cash discounts, coupon reimbursements, ad or rack allowances, buy-downs, scanbacks, voluntary price reductions and other incentives, promotions, and rebates. Under certain conditions, payments received by the retailer in the form of rebates or other types of payments or credits for products sold at retail are included in the retailer's gross receipts or sales price from the sale of the product.</p> <p>For purposes of this regulation, the following definitions shall apply:</p> <p>(1) "DISCOUNT" means a reduction in the amount of consideration the customer is required to pay in order to purchase products from a retailer.</p> <p>(2) "DOCUMENTATION" means a written representation or other written notification that third-party consideration has been or will be provided to the retailer. Examples of "documentation" include, but are not limited to, contracts, sales invoices, manufacturer or vendor coupons, gift certificates, customer receipts, and assignments of rebates. The written representation may be on paper or through electronic or any other</p>

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	<p>(b) DISCOUNTS.</p> <p>(1) CASH DISCOUNTS are offered by a retailer to its customer for prompt payment by that customer. If the customer makes prompt payment and takes the discount, the retailer's gross receipts are reduced by the amount of the discount. Cash discounts allowed and taken on sales are excluded from gross receipts. If, however, the customer does not make prompt payment, the retailer's gross receipts are the amount billed. Generally, discounts provided to customers utilizing a grocery store discount club card are regarded as cash discounts or retailer coupons.</p> <p>(2) PURCHASE DISCOUNTS are given by a manufacturer and/or wholesaler to a vendor (i.e., a retailer) based upon the amount of prior or future purchases by that vendor. These discounts are regarded as trade discounts and are excluded from gross receipts as they are based on the number of products the retailer purchased from the manufacturer and/or wholesaler and not the number of products sold by the vendor at retail. Agreements</p>	<p>means.</p> <p>“Documentation” does not mean signage, display tags, advertisement in a newspaper or other materials, flyers, promotional materials, statements on the customer’s receipt such as “you saved \$18 today,” or other such general written representations. Written representations of this type do not directly notify the customer of the third-party compensation that will be provided to the retailer to compensate for the reduction in the amount the customer is required to pay.</p> <p>(3) “THIRD PARTY” means a person other than the retailer or the retailer’s customer, such as a manufacturer or retailer’s vendor.</p> <p>(b) DISCOUNTS</p> <p>(1) CASH DISCOUNTS are offered by a retailer to its customer for prompt payment by that customer. If the customer makes prompt payment and takes the discount, the retailer's gross receipts are reduced by the amount of the discount. Cash discounts allowed and taken on sales are excluded from gross receipts. If, however, the customer does not make prompt payment, the retailer's gross receipts are the amount billed. Generally, discounts provided to customers utilizing a grocery store discount club card are regarded as cash discounts or retailer coupons.</p> <p>(2) PURCHASE DISCOUNTS are given by a manufacturer and/or wholesaler to a vendor (i.e., a retailer) based upon the amount of prior or future purchases by that vendor. These discounts are regarded as trade discounts and are excluded from gross receipts as they are based on the number of products the retailer purchased from the manufacturer and/or wholesaler and not the number of products sold by the vendor at retail. Agreements</p>

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	<p>wherein the retailer agrees to sell the products at a target price for a period of time are also "purchase discounts" and excluded from gross receipts when the discount is based on the number of products purchased by the vendor. The rebates received either directly from the manufacturer or from the wholesaler are not subject to tax since they are tied to the retailer's wholesale purchases of the products, not to the number of retail sales made at the target price.</p> <p>(3) AD OR RACK ALLOWANCES are contractual agreements usually between a manufacturer and the retailer to advertise a product, or to give that product preferential shelf space. Ad or rack allowances are also known as "Local Pay," "Display Shelf Payments," or something similar. Such allowances are not related to the retail sale of the underlying product and are excluded from gross receipts. Generally, payments to a grocery store retailer pursuant to discounts offered through a grocery store discount club card are regarded as ad or rack allowances.</p> <p>(4) RETAILER COUPONS are issued by a retailer in paper or paperless form. When presented to the retailer by the customer, they entitle the customer to buy tangible personal property at a certain amount or percentage off the advertised selling price. Although the coupons are presented to the retailer to receive a reduction in the selling price, retailer coupons do not result in compensation from a third party. If the customer has not paid any consideration for the coupon, e.g., a coupon clipped from a magazine or newspaper, the coupon represents a true price reduction resulting in a corresponding reduction in the retailer's gross receipts from the sale. If, however, the customer</p>	<p>wherein the retailer agrees to sell the products at a target price for a period of time are also "purchase discounts" and excluded from gross receipts when the discount is based on the number of products purchased by the vendor. Even if customer knowledge through documentation were present, the rebates received either directly from the manufacturer or from the wholesaler are not subject to tax since they are tied to the retailer's wholesale purchases of the products, not to the number of retail sales made at the target price.</p> <p>(3) AD OR RACK ALLOWANCES are contractual agreements usually between a manufacturer and the retailer to advertise a product, or to give that product preferential shelf space. Ad or rack allowances are also known as "Local Pay," "Display Shelf Payments," or something similar. Such allowances are not related to the retail sale of the underlying product and are excluded from gross receipts. Generally, payments to a grocery store retailer pursuant to discounts offered through a grocery store discount club card are regarded as ad or rack allowances.</p> <p>(4) RETAILER COUPONS are issued by a retailer in paper or paperless form. When presented to the retailer by the customer, they entitle the customer to buy tangible personal property at a certain amount or percentage off the advertised selling price. Although the coupons are presented to the retailer to receive a reduction in the selling price, retailer coupons do not result in compensation from a third party. If the customer has not paid any consideration for the coupon, e.g., a coupon clipped from a magazine or newspaper, the coupon represents a true price reduction resulting in a corresponding reduction in the retailer's gross receipts from the sale. If, however, the customer</p>

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	<p>has previously given compensation to the retailer for the coupon, e.g., the coupon was purchased as part of a coupon booklet sold by the retailer to the customer, the pro rata share of the cost of the booklet represented by the purchase for which the coupon was given must be included in gross receipts.</p> <p>(5) MANUFACTURER COUPONS are paper or paperless coupons funded by the manufacturer that customers can utilize at the time of purchasing the manufacturer's product, thus entitling customers to a certain amount or percentage off the advertised selling price. These coupons are generally identified as "manufacturer coupons" and include retailer reimbursement terms that must be followed by retailers in order to redeem the coupons. Amounts paid by a manufacturer to a retailer to reimburse the retailer for the value of the manufacturer coupon are included in the retailer's gross receipts. The retailer may, by contract, charge the customer sales tax reimbursement on the amount paid by the manufacturer. When a retailer charges such reimbursement, the amount on which the reimbursement is charged is fully disclosed to the customer through the customer's utilization of the manufacturer coupon.</p> <p>(c) REBATES AND INCENTIVES.</p> <p>(1) DEFINITIONS. For purposes of this subdivision only, the following definitions shall apply:</p> <p>(A) "Discount" means a reduction in the amount of consideration the customer is required to provide in order to purchase the tangible personal property from a retailer as a result of third-party consideration promised to or received by the retailer.</p>	<p>has previously given compensation to the retailer for the coupon, e.g., the coupon was purchased as part of a coupon booklet sold by the retailer to the customer, the pro rata share of the cost of the booklet represented by the purchase for which the coupon was given must be included in gross receipts.</p> <p>(5) MANUFACTURER COUPONS are paper or paperless coupons funded by the manufacturer that customers can utilize at the time of purchasing the manufacturer's product, thus entitling customers to a certain amount or percentage off the advertised selling price. These coupons are generally identified as "manufacturer coupons" and include retailer reimbursement terms that must be followed by retailers in order to redeem the coupons. Amounts paid by a manufacturer to a retailer to reimburse the retailer for the value of the manufacturer coupon are included in the retailer's gross receipts. The retailer may, by contract, charge the customer sales tax reimbursement on the amount paid by the manufacturer. When a retailer charges such reimbursement, the amount on which the reimbursement is charged is fully disclosed to the customer through the customer's utilization of the manufacturer coupon.</p> <p>(c) REBATES AND INCENTIVES</p>

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	<p>(B) “Retailer’s vendor” means a person who sells tangible personal property for resale directly to the retailer.</p> <p>(C) Operative October 1, 2007, “third party” means a person other than the retailer or the retailer’s customer, such as a manufacturer or retailer’s vendor.</p> <p>(2) REBATES ISSUED DIRECTLY TO CUSTOMERS. Manufacturers engage in promotional programs in which they offer product rebates directly to the retailer’s customers following their purchase of the manufacturer’s products. To receive the product rebate, customers are generally required to submit a rebate application form along with any required documentation (e.g., sales receipt) to the manufacturer or manufacturer’s representative directly or through the retailer. Once the rebate form and required documents are processed and accepted, the manufacturer or the manufacturer’s representative will issue the customer a rebate check. Rebates checks issued by manufacturers directly to the retailer’s customers are not part of the retailer’s gross receipts. In this situation, the customer pays the retailer the full selling price and receives a subsequent rebate directly from the manufacturer.</p> <p>(3) REBATES AND INCENTIVES ISSUED TO RETAILERS. Retailers engage in rebate and incentive programs with manufacturers or other third parties that result in additional revenue for the retailer when certain conditions are satisfied. These are transactions involving buy-down programs, markdowns, discounts, coupons, rebates, and other price reductions. These rebate and incentive programs are also known as “Buy-Down Rebates,” “Voluntary Price Reductions” “Promotions,” “Flex”</p>	<p>(1) REBATES ISSUED DIRECTLY TO CUSTOMERS. Manufacturers engage in promotional programs in which they offer product rebates directly to the retailer’s customers following their purchase of the manufacturer’s products. To receive the product rebate, customers are generally required to submit a rebate application form along with any required documentation (e.g., sales receipt) to the manufacturer or manufacturer’s representative directly or through the retailer. Once the rebate form and required documents are processed and accepted, the manufacturer or the manufacturer’s representative will issue the customer a rebate check. Rebates checks issued by manufacturers directly to the retailer’s customers are not part of the retailer’s gross receipts. In this situation, the customer pays the retailer the full selling price and receives a subsequent rebate directly from the manufacturer.</p> <p>(2) REBATES AND INCENTIVES ISSUED TO RETAILERS. Retailers engage in rebate and incentive programs with manufacturers or other third parties that result in additional revenue for the retailer when certain conditions are met. These are transactions involving buy-down programs, markdowns, discounts, coupons, rebates, and other price reductions. These rebate and incentive programs are also known as “Buy-Down Rebates,” “Voluntary Price Reductions” “Promotions,” “Flex”</p>

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	<p>(Flex Extensions), “Coupon Redemptions,” “Scanbacks,” “Instant Rebates,” or by a similar name.</p> <p>(A) Operative October 1, 2007, when a retailer enters into an oral or written contract with a manufacturer or other third party that requires, on a transaction-by-transaction basis, a specific reduction in the retailer’s selling price of specified products in exchange for a certain payment of a like amount from the contracting party (e.g., a payment that is not contingent upon selling a particular amount of the specified products), such payments received by the retailer are part of the taxable gross receipts or sales price of the sales. For purposes of this subdivision, it is rebuttably presumed that any consideration received by retailers from third parties related to promotions for sales of specified products is subject to tax until the contrary is established. The types of documentation that will generally rebut this presumption include, but are not limited to, the following:</p> <ol style="list-style-type: none"> 1. A copy of an agreement or contract between the retailer and a third party that requires the retailer to give specified products preferential shelf space or to display the products in specific areas of the retailer’s establishment in exchange for the payment received. 2. A copy of an agreement or contract between the retailer and a third party that provides the retailer with an advertising allowance, equal to or in excess of the payment received, when the retailer advertises the third-party’s products. 3. A copy of an agreement or contract between the retailer and a third party that provides that the retailer will only receive the payment if the retailer sells a certain quantity of the products within 	<p>(Flex Extensions), “Coupon Redemptions,” “Scanbacks,” “Instant Rebates” or by a similar name.</p> <p>Revenue received by the retailer from these types of programs or other similar types of programs is part of the retailer’s gross receipts (or sales price if subject to use tax) from the sale to a customer when both of the following conditions are met:</p> <p>(A) Receipt of the rebate or incentive revenue is conditioned upon the retailer’s sale of the product at a reduced selling price. A conditional price reduction exists when the manufacturer, vendor, or other third party requires, through a written or oral contract, the retailer to reduce the retailer’s selling price of the product from the regular selling price. The price reduction can be a specific amount or a requirement to not exceed a specified reduced selling price.</p> <p>(B) The customer has knowledge that the manufacturer, vendor, or other third party will reimburse the retailer for the amount of the price reduction. Customer knowledge of the additional reimbursement is present when the customer presents “documentation” to the retailer to obtain the price reduction or the “documentation” presented to the customer at the time of sale indicates there is a price reduction.</p> <p>Both conditions must be met for the rebate or incentive revenue to be considered part of the retailer’s gross receipts. If both of the conditions are not met, the rebate or incentive revenue will not be includable in the retailer’s gross receipts.</p>

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	<p>a specified price range during a particular period, or if the retailer purchases a certain quantity of the products during a particular period.</p> <p>4. In the absence of a written agreement or contract, the retailer may use any verifiable method of establishing that the consideration received from the third party was not subject to tax, such as a signed and dated letter or other type of documentation provided by the third party, subsequent to the contract or agreement, verifying that the payment received was not paid pursuant to a contract requiring a reduction in the selling price of specified products on a transaction-by-transaction basis.</p> <p>(B) Operative October 1, 2007, for purposes of this subdivision, when a retailer contracts with its customer for the addition of sales tax reimbursement to the gross receipts of tangible personal property sold at retail, or when a retailer is obligated to collect use tax measured by the sales price, the retailer is required to disclose to the customer the amount upon which sales tax reimbursement or use tax is collected, including the amount of any taxable discounts, rebates, or incentives offered or paid to the retailer by third parties. The retailer may show the amount upon which sales tax reimbursement or use tax is collected on the customer's sales receipt, sales invoice, or other proof of sale. When applicable, the retailer may also post on its premises in a location visible to the customer, or in an advertisement or other printed material directed to customers, a notice to the effect that "tax" will be added to the selling price of all items, including the amount of any taxable discounts, rebates, or incentives offered or paid to the retailer by third parties.</p> <p>A retailer that does not disclose the amount of any</p>	

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	<p>taxable discounts, rebates, or incentives upon which sales tax reimbursement is collected, is in violation of the provisions of Regulation 1700, <i>Reimbursement for Sales Tax</i>. A retailer obligated to collect the use tax that does not disclose the amount of any taxable discounts, rebates, or incentives is in violation of the provisions of Regulation 1686, <i>Receipts for Tax Paid to Retailers</i>.</p> <p>(d) EXAMPLES.</p> <p>(1) The following are examples of transactions where the value of the coupon or discount is part of the retailer's gross receipts (or sales price if subject to use tax) from the sale of the product:</p> <p>(A) Customer clips a coupon out of a newspaper and presents it to the retailer at the time of sale to receive a discounted price on the product purchased. The coupon indicates "Manufacturer Coupon." Since the manufacturer will compensate the retailer for the amount of the price reduction and the customer presents a manufacturer coupon to the retailer, the value of the coupon is included in the retailer's gross receipts.</p> <p>(B) Coupon on dog food bag indicates \$2 off at register. The coupon also indicates "payable by Big Bad Dog Food Co. (BBDF Co.)" or "All promotional costs paid by BBDF Co." The store clerk removes the coupon from the dog food bag and enters the amount of the discount into the register. The discount is included in the retailer's gross receipts.</p> <p>(C) Retailer provides its customers with a coupon discount booklet containing coupons accepted by the retailer during sales periods. The booklet includes coupons identified as "manufacturer coupons" and retailer coupons. Customers remove the coupons from the booklet</p>	<p>(d) EXAMPLES.</p> <p>(1) The following are examples of transactions where the value of the coupon or discount is part of the retailer's gross receipts (or sales price if subject to use tax) from the sale of the product:</p> <p>(A) Customer clips a coupon out of the newspaper and presents it to the retailer at the time of sale to receive a discounted price on the product purchased. The coupon indicates "Manufacturer Coupon." Since the manufacturer will compensate the retailer for the amount of the price reduction and the customer presents a manufacturer coupon to the retailer, the value of the coupon is included in the retailer's gross receipts.</p> <p>(B) Display aisle has a coupon dispenser above a display of cereal boxes. The dispensed coupons indicate \$1 off "Fruity Juice Cereal" - "Manufacturer Coupon." The customer presents the coupon to the retailer along with the box of cereal and is given \$1 off the product's selling price. The value of the coupon is subject to tax.</p> <p>(C) Coupon on dog food bag indicates \$2 off at register. The coupon also indicates "payable by Big Bad Dog Food Co. (BBDF Co.)" or "All promotional costs paid by BBDF Co." The store clerk removes the coupon from the dog food bag and rings up the original price and the amount of the discount. The customer's sales receipt lists the \$2</p>

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	<p>and present them to the check-out clerk. The value of the coupons identified as “manufacturer coupons” is included in the retailer’s gross receipts. The value of the retailer coupons, however, would generally not be included in the retailer’s gross receipts.</p> <p>(2) The following are examples of transactions where rebate or incentive payments are part of the retailer’s gross receipts (or sales price if subject to use tax) from the sale of the product:</p> <p>(A) The retailer purchases dog food from a distributor, a separate legal entity from the manufacturer (BBDF Co.). No coupon is present on the dog food bag. However, a display notice indicates that a \$2 “price reduction is made possible by BBDF Co.” Since the retailer agrees to reduce the selling price of the product in exchange for an offsetting reimbursement from the distributor, the discounted amount is included in the retailer’s gross receipts.</p>	<p>discount. The amount of the discount is subject to tax.</p> <p>(D) Retailer provides its customers with a coupon discount booklet containing coupons accepted by the retailer during sales periods. The booklet includes coupons identified as “manufacturer coupons” and non-identified coupons. Customers remove the coupons from the booklet and present them to the check-out clerk. The value of the coupons identified as “manufacturer coupons” is included in the retailer’s gross receipts. The value of the non-identified coupons, however, would generally not be included in the retailer’s gross receipts.</p> <p>(2) The following are examples of transactions where rebate or incentive payments are part of the retailer’s gross receipts (or sales price if subject to use tax) from the sale of the product:</p> <p>(A) The retailer purchases dog food from a distributor, a separate legal entity from the manufacturer (BBDF Co.). No coupon is present on the dog food bag. However, a display notice indicates that a \$2 “price reduction is made possible by BBDF Co.” The amount of \$2 is separately itemized on the customer’s receipt and identified as a BBDF discount. Since the retailer agrees to reduce the selling price of the product and the customer is provided a receipt (“documentation”) identifying the amount of the manufacturer’s discount, the discounted amount is included in the retailer’s gross receipts. If the customer’s receipt did not identify the discount as a manufacturer discount, however, the required conditions would not be met. The display notice does not qualify as “documentation.”</p>

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	<p>(B) The retailer maintains an online sales Web site. The retailer enters into buy-down programs with manufacturers in which the manufacturers require the retailer to offer their products at a reduced price. When the customer purchases a discounted product, the customer's invoice lists the selling price less the amount of the manufacturer's discount. The amount of the discount is subject to tax.</p> <p>(C) Retailer offers a grocery store discount club card. The customer uses the club card when purchasing various products. The customer also presents manufacturer coupons to the store clerk that are scanned along with the club card. Although the price reductions associated with the club card are not part of the retailer's gross receipts, the value of the manufacturer coupons is included in gross receipts.</p> <p>(D) Retailer purchases cosmetic products directly from the manufacturer. The manufacturer and retailer enter into a buy-down program in which the retailer is required to reduce the selling price of the manufacturer's products. In turn, the manufacturer agrees to compensate the retailer for the amount of the price reduction. The rebate revenue is included in the retailer's gross receipts.</p>	<p>(B) The retailer maintains an online sales Web site. The retailer enters into buy-down programs with manufacturers in which the manufacturers require the retailer to offer their products at a reduced price. When the customer purchases a discounted product, the customer's invoice lists the selling price less the amount of the manufacturer's discount. The discounted amount is identified as a "manufacturer's rebate." In addition to a receipt the customer may print, the retailer also e-mails a confirmation to the customer with a copy of the sales data and the rebate information. The discounted amount is subject to tax.</p> <p>(C) Retailer offers a grocery store discount club card. The customer uses the club card when purchasing various products. The customer also presents manufacturer coupons to the store clerk that are scanned along with the club card. The customer's receipt contains the following statement: "You saved \$8 today." Although the price reductions associated with the club card are generally not part of the retailer's gross receipts, the value of the manufacturer coupons is included in gross receipts.</p> <p>(D) Retailer purchases cosmetic products directly from the manufacturer. The manufacturer and retailer enter into a buy-down program in which the retailer is required to reduce the selling price of the manufacturer's products. In turn, the manufacturer agrees to compensate the retailer for the amount of the price reduction. The cosmetic packaging includes a coupon with the following statement: \$5 off courtesy of Sun Image Cosmetics. The customer presents the coupon to the clerk and is given \$5 off the regular selling price. The rebate revenue is included in the retailer's gross receipts.</p>

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	<p>(E) A cola distributor enters into graduated rebate agreements with retailers that entitle the retailers to reimbursement from the distributor based on the number of 12-packs of cola the retailers sell at a required discounted price during the month of July. The amount of the sales discount is dictated by the distributor as follows. A participating retailer is certain to receive 50 cents for every 12-pack of cola the retailer sells in July at the required discounted price. However, after surpassing a minimum threshold of 12-pack units sold, the retailer will receive an additional 50 cents for each additional 12-pack sold over the threshold minimum. At the end of the promotional period, after verifying the number of 12-pack units sold, the distributor issues a rebate check to the participating retailer. Only the certain payment of 50 cents for every 12-pack of cola the retailer sells in July at the required discounted price is subject to tax. To the extent the retailer receives additional rebates for exceeding the minimum threshold, such contingent rebates are not subject to tax.</p> <p>(3) The following are examples of transactions where the value of the coupon or discount is not included in the retailer's gross receipts (or sales price if subject to use tax) from the sale of the product:</p> <p>(A) Retailer has store discount coupons printed in newspaper advertisements. The customers present the coupons when purchasing the advertised products. The retailer's coupon is not a third-party coupon, nor is the retailer reimbursed for the amount of the discount. Although the customers may present a coupon to the retailer, the amount of the discount is not included in the retailer's gross</p>	<p>(E) A cola distributor enters into graduated rebate agreements with retailers that entitle the retailers to reimbursement from the distributor based on the number of 12-packs of cola the retailers sell at a required discounted price during the month of July. The amount of the sales discount is dictated by the distributor as follows. A participating retailer is certain to receive 50 cents for every 12-pack of cola the retailer sells in July at the required discounted price. However, after surpassing a minimum threshold of 12-pack units sold, the retailer will receive an additional 50 cents for each additional 12-pack sold over the threshold minimum. At the end of the promotional period, after verifying the number of 12-pack units sold, the distributor issues a rebate check to the participating retailer. If customer knowledge through documentation is present, only the certain payment of 50 cents for every 12-pack of cola the retailer sells in July at the required discounted price is subject to tax. To the extent the retailer receives additional rebates for exceeding the minimum threshold, such contingent rebates are not subject to tax.</p> <p>(3) The following are examples of transactions where the value of the coupon or discount is not included in the retailer's gross receipts (or sales price if subject to use tax) from the sale of the product:</p> <p>(A) Retailer has store discount coupons printed in newspaper advertisements. The customers present the coupons when purchasing the advertised products. The retailer's coupon is not a third-party coupon, nor is the retailer reimbursed for the amount of the discount. Although the customers may present a coupon to the retailer, the amount of the discount is not included in the retailer's gross</p>

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	<p>receipts.</p> <p>(B) Retailer advertises a special promotional sale to a specific customer base. Qualifying customers are mailed a 25% discount coupon they may use on the last Tuesday of the month. The customers are required to bring the coupon to the store during the promotional period in order to receive a discount on their purchases. The retailer is not reimbursed by a third party for the discounted amount. The discounts provided to the retailer's customers qualify as nontaxable discounts.</p> <p>(C) Retailer offers a "double discount" for certain manufacturer coupons used by customers. The customers present a manufacturer coupon offering \$1 off the purchase of a specific healthcare product. In turn, the retailer also allows an additional \$1 off the selling price of the healthcare product. Although the value of the reimbursable manufacturer coupon is included in the amount subject to tax, the retailer's additional \$1 discount qualifies as a nontaxable discount.</p> <p>(4) The following are examples of transactions where rebate and incentive payments are not included in the retailer's gross receipts (or sales price if subject to use tax) from the sale of the product:</p> <p>(A) A cola distributor enters into written agreements with retailers that entitle the retailers to compensation from the distributor based on the number of 12-packs of cola the retailers sell during the month of July. The retailers retain copies of the agreements. The retailers may or may not reduce the selling price of the 12-packs. At the end of the promotional period, the distributor issues rebate checks to the participating retailers. Given the</p>	<p>receipts.</p> <p>(B) Using the example from (d)(1)(D), except in this case, the store register automatically rings up the discounted price or the store clerk scans a coupon from a packet of coupons when the customer does not present the required coupon. Although the customer's receipt shows the amount of the discount, it is not identified as a third-party discount. Thus, the amount of the discount is not included in the retailer's gross receipts. The customer did not present "documentation" to the store clerk, nor was the customer provided "documentation" at the time of sale.</p> <p>(4) The following are examples of transactions where rebate and incentive payments are not included in the retailer's gross receipts (or sales price if subject to use tax) from the sale of the product:</p> <p>(A) Coupon on a dog food bag says \$2 off at register. There is no indication on the coupon, on the customer's receipt, or on any other related documentation that the retailer will receive \$2 from another party to compensate for the \$2 price reduction. Whether or not the price reduction is based on an agreement with a third party to reduce the selling price of the dog food, the customer did not present or receive "documentation" that</p>

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	<p>retailers can document there was no requirement to reduce the selling price of the product, the additional revenue is not included in the retailers' gross receipts.</p> <p>(B) A manufacturer enters into written agreements with retailers to advertise the manufacturer's products and to provide the products preferential shelf space. Retailers that agree to the manufacturer's terms receive compensation from the manufacturer at the end of the promotional period. Assuming the retailers can document that the agreements were not based on a selling price reduction, the payments from the manufacturer are not included in the retailers' gross receipts.</p> <p>(C) A retailer's vendor agrees to discount the retailer's November purchases of Christmas products by 20% if the retailer's total sales for October exceed a specific amount. The retailer increases its purchases during October, gives the products preferential shelf space and advertises the products at 10% off. Although the retailer reduced the selling price of the products, a price reduction was not a condition of the agreement. The retailer retains documentation to support this fact. The discount is a reduction to the retailer's cost of good sold, not additional gross receipts.</p> <p>(D) A manufacturer's representative enters into an agreement with a retailer that entitles the retailer to compensation from the manufacturer if the retailer's sales of the manufacturer's hair and skin care products exceed a specific amount during the month of June. The retailer offers the products at a reduced price and provides the hair care products with preferential shelf space. The retailer's</p>	<p>demonstrates the customer had knowledge of the reimbursement from a third party.</p> <p>(B) A cola distributor enters into agreements with retailers that entitle the retailers to compensation from the distributor based on the number of 12-packs of cola the retailers sell during the month of July. The retailers may or may not reduce the selling price of the 12-packs. At the end of the promotional period, the distributor issues rebate checks to the participating retailers. Even if customer knowledge through documentation were present, since the retailer is not required to reduce the selling price of the product, the additional revenue is not included in the retailer's gross receipts.</p> <p>(C) A manufacturer enters into agreements with retailers to advertise the manufacturer's products and to provide the products with preferential shelf space. Retailers that agree to the manufacturer's terms receive compensation from the manufacturer at the end of the promotional period. Since the agreements are not based on a selling price reduction, the payments are not included in the retailers' gross receipts.</p> <p>(D) A retailer's vendor agrees to discount the retailer's November purchases of Christmas products by 20% if the retailer's total sales for October exceed a specific amount. The retailer increases its purchases during October, gives the products preferential shelf space and advertises the products at 10% off. Although the retailer reduced the selling price of the products, a price reduction</p>

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	<p>sales for June exceed the specified amount and the manufacturer issues a check to the retailer, as agreed. The rebate payment is not subject to tax.</p> <p>(E) A retailer buys products from either a wholesaler or the manufacturer of products. Retail sales of these products are generally subject to tax. The product manufacturer and/or the wholesaler enters into an agreement with the retailer for a rebate, based upon the number of products the retailer purchases from either the manufacturer or the wholesaler, if the retailer agrees to sell the products at a “target” price for a specified period. Typically, a target price is used to establish a general price range for a particular geographic area or demographic market. The rebates received either directly from the manufacturer or from the wholesaler are not subject to tax since they are tied to the retailer’s wholesale purchases of the products, not to the number of retail sales made at the target price.</p> <p>(F) During a routine audit of the retailer’s books and records, the retailer is asked to provide documentation to support its nontaxable treatment of the revenue received; however, the retailer does not have sufficient documentation to support its reporting of the transactions in question. To verify that the revenue received from the manufacturer was not part of gross receipts, the retailer sends a letter to the manufacturer requesting that the manufacturer verify that the payment received under their promotional agreement was not paid pursuant to a contract requiring the retailer to reduce the selling price of their products. The manufacturer signs and dates the letter verifying this fact and returns it to the retailer. No concerns regarding the authenticity of the letter exist. Since the subsequent verification establishes that the rebate revenue was not paid in</p>	<p>was not a condition of the agreement. The purchase discount is a reduction to the retailer’s cost of good sold, not additional gross receipts.</p> <p>(E) A retailer buys products from either a wholesaler or the manufacturer of products. Retail sales of these products are generally subject to tax. The product manufacturer and/or the wholesaler enters into an agreement with the retailer for a rebate, based upon the number of products the retailer purchases from either the manufacturer or the wholesaler, if the retailer agrees to sell the products at a “target” price for a specified period. Typically, a target price is used to establish a general price range for a particular geographic area or demographic market. Even if customer knowledge through documentation were present, the rebates received either directly from the manufacturer or from the wholesaler are not subject to tax since they are tied to the retailer’s wholesale purchases of the products, not to the number of retail sales made at the target price.</p>

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	<p>exchange for a required reduction to the retailer's selling price of the manufacturer's products, the revenue is not part of the retailer's gross receipts.</p> <p>(5) The following are examples of transactions involving payments by automobile manufacturers to automobile dealers or end-use customers with respect to the sale or lease of automobiles.</p> <p>(A) An automobile manufacturer provides a customer with a \$1,000 rebate upon the purchase of a specific automobile. Rather than receive payment from the manufacturer, the customer assigns the rebate to the dealer, who in turn applies the amount of that rebate toward the customer's payment for the vehicle. The \$1,000 payment by the manufacturer is part of the dealer's gross receipts, since the rebate is provided to the customer who uses the rebate amount to partially satisfy that customer's total payment obligation to the dealer. The \$1,000 rebate does not constitute a reduction in the retailer's gross receipts as a retailer's coupon, cash discount, purchase discount, or otherwise.</p> <p>(B) An automobile dealer receives a \$500 incentive from the automobile manufacturer for every vehicle sold of a specific model in a given period. The manufacturer does not have an oral or written contract requiring the dealer to sell the specific model at a reduced price. The selling price is based solely on the dealer's discretion. Under these facts, the \$500 payment by the manufacturer is not part of the dealer's gross receipts since the manufacturer does not require a reduction in the retail selling price of the vehicle. The \$500 incentive instead constitutes a reduction in the dealer's cost of goods sold.</p>	<p>(5) The following are examples of transactions involving payments by automobile manufacturers to automobile dealers or end-use customers with respect to the sale or lease of automobiles.</p> <p>(A) An automobile manufacturer provides a customer with a \$1,000 rebate upon the purchase of a specific automobile. Rather than receive payment from the manufacturer, the customer assigns the rebate to the dealer, who in turn applies the amount of that rebate toward the customer's payment for the vehicle. The \$1,000 payment by the manufacturer is part of the dealer's gross receipts, since the rebate is provided to the customer who uses the rebate amount to partially satisfy that customer's total payment obligation to the dealer. The \$1,000 rebate does not constitute a reduction in the retailer's gross receipts as a retailer's coupon, cash discount, purchase discount, or otherwise.</p> <p>(B) An automobile dealer receives a \$500 incentive from the automobile manufacturer for every vehicle sold of a specific model in a given period. The manufacturer does not have an oral or written contract requiring the dealer to sell the specific model at a reduced price. The selling price is based solely on the dealer's discretion. Under these facts, the \$500 payment by the manufacturer is not part of the dealer's gross receipts since the manufacturer does not require a reduction in the retail selling price of the vehicle. The \$500 incentive instead constitutes a reduction in the dealer's cost of goods sold.</p>

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BOARD OF EQUALIZATION
KEY AGENCY ISSUE

- ☐ Board Meeting
- ☒ Business Taxes Committee
- ☐ Customer Services and Administrative Efficiency Committee
- ☐ Legislative Committee
- ☐ Property Tax Committee
- ☐ Other

Proposed Regulation 1671.1, Discounts, Coupons, Rebates, and Other Incentives

I. Issue

Should the Board of Equalization (Board) adopt proposed Regulation 1671.1, *Discounts, Coupons, Rebates, and Other Incentives*, to clarify the application of tax to third-party rebates?

II. Alternative 1 – Staff Recommendation

Staff recommends the adoption of proposed new Regulation 1671.1 as illustrated in Exhibit 2. Staff's version provides that rebate revenues are part of the retailer's gross receipts or sales price (when use tax applies) when: (1) the rebate program is between the retailer and a third party (i.e., someone other than the retailer's customer) *and* (2) receipt of the rebate is contingent upon a specified reduction in the retailer's selling price of particular products in exchange for a certain payment of a like amount from the third party. In response to concerns raised by various interested parties, staff's proposal eliminates the two-party/three-party distinction to reflect a modification to staff's current approach. Currently, rebate revenues are taxed differently depending on whether or not the retailer's rebate agreement is with the retailer's direct vendor. Staff recommends an operative date of October 1, 2007, that would only apply to the elimination of the two-party/three-party distinction, the rebuttable presumption that rebate revenue received from third parties is taxable until the contrary is established, and the requirement that retailers disclose the amount upon which tax or tax reimbursement (hereafter, collectively, tax) is collected, including any taxable discounts or rebates.

Like Alternative 2, staff's version of proposed new Regulation 1671.1 represents a joint effort by staff and interested parties to clarify the application of tax to third-party rebates, and to clarify other noncontroversial coupon, rebate, and discount issues.

III. Alternative 2 – Industry Recommendation

As supported by the California Grocers Association, California Retailers Association, California Chamber of Commerce, and Western States Petroleum Association (hereafter, collectively, Industry), adopt Industry's version of proposed new Regulation 1671.1, as illustrated in Exhibit 3. Industry's version regards a retailer's rebate revenue as subject to tax when the following conditions are satisfied: (1) the rebate program is between the retailer and a party other than the retailer's customer (third party), (2) receipt of the rebate is conditioned upon a specified reduction in the retailer's selling price of particular products, and (3) the customer has direct knowledge, through documentation given or received by the customer at the time of retail sale, of the payment by the third party to reimburse the retailer for the amount of the reduction in selling price. Although not recommended by staff, to the extent the Board approves Industry's version, staff believes the proposed approach is reasonable. Industry's proposal has no operative date and would therefore, be declarative of existing law with a retroactive impact.

Like Alternative 1, Industry's version also represents a joint effort by staff and interested parties to clarify the application of tax to third-party rebates, and to clarify other noncontroversial coupon, rebate, and discount issues.

IV. Background

Retailers and their representatives have disputed the application of tax to certain rebates, incentives, and buy-downs (hereafter, collectively, “third-party rebates”) in recent years. At its January 31, 2006 meeting, the Board directed staff to prepare proposed language for two or more alternative approaches to the taxation of third-party rebates for the Board to consider in a regulatory process. Staff presented four alternative approaches during the March 28, 2006 Board meeting. The four alternative approaches included an approach inspired by the Streamlined Sales and Use Tax Agreement, prior staff and industry approaches presented to the Board at its August 6, 2003 Business Taxes Committee meeting, and a final approach that reflects the Sales and Use Tax Department’s (Department) current methodology. After a discussion regarding the four approaches, the Board referred all four alternatives to the Business Taxes Committee’s interested parties process for further discussion.

Staff held the first interested parties meeting to discuss the alternative approaches on July 25, 2006. The general consensus of the interested parties was that the application of tax to third-party rebates should be tied to “document-based” customer knowledge of the payment made by a third party to the retailer in exchange for a reduction to the retailer’s selling price of specified products. To accomplish this, interested parties indicated support for merging two of the alternative approaches into a new proposed Regulation 1671.1, with additional examples and clarification. The interested parties also expressed a preference for a comprehensive regulation with provisions that address all types of coupons, discounts, and rebate issues.

At the second interested parties meeting held on September 19, 2006, staff and Industry agreed there should be no distinction between direct-vendor and non-direct-vendor rebate transactions when the transactions involve promotional programs in which a third party requires the retailer to reduce the selling price of certain products in exchange for payment by the third party for the amount of the price reduction. For the purposes of proposed new Regulation 1671.1, it was agreed that a “third party” should be defined as “a person other than the retailer or the retailer’s customer, such as a manufacturer or retailer’s vendor” as previously proposed by Industry.

Also discussed was staff’s intention to revise its previously proposed language to include the concepts currently reflected in staff’s version of proposed new Regulation 1671.1, subdivision (c) (Exhibit 2), with an operative date of October 1, 2007. Staff discussed the inclusion of a *rebuttable presumption* that revenue received by a retailer under a rebate or incentive program was received pursuant to an oral or written contract with a third party requiring the retailer to reduce the selling price of specified products in exchange for a certain payment of a like amount from the third party, on a transaction-by-transaction basis, until the contrary is established. Staff also discussed how this presumption could be rebutted in a way that would not be unduly burdensome where the rebate revenue was, in fact, not connected to a required reduction in selling price. Staff further discussed requiring retailers to disclose to their customers the amounts of taxable rebate revenue on which they collect tax to minimize confusion regarding how the measure of tax was calculated.

V. Discussion

Gross Receipts or Sales Price: In general, California imposes a sales tax on a retailer’s gross receipts from the retail sale of tangible personal property in this state unless the sale is specifically exempt from tax by statute. Sales tax is imposed on the retailer who may collect reimbursement from the customer if the contract of sale so provides. Where sales tax does not apply, such as when the sale takes place outside the state, use tax is imposed on the sales price of property purchased from a retailer for the

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storage, use, or other consumption of property inside this state. Gross receipts or sales price include the total amount received with respect to the sale, with no deduction for the cost of materials, service, or expense of the retailer passed on to the purchaser, unless there is a specific statutory exclusion. Pursuant to Revenue and Taxation Code (RTC) sections 6011(b)(2) and 6012(b)(3), respectively, sales price and gross receipts also include any amount for which the seller gives a credit to the purchaser. However, pursuant to RTC sections 6011(c)(1) and 6012(c)(1), respectively, sales price and gross receipts do not include cash discounts allowed and taken on sales.

Gross receipts (and sales price when use tax applies) are not limited to amounts collected from the customer. In the case of rebates tied to specific price reductions at the time of retail sale, the gross receipts received by a retailer have historically been regarded as the amount charged the customer, plus the amount received pursuant to the relevant rebate agreement. (See, e.g., *Szabo Food Service, Inc., of Cal. v. State Bd. of Equalization* (1975) 46 Cal.App.3d 268.) Retailers who receive a certain reimbursement from manufacturers through coupon rebates or through rebate revenues from a third party in exchange for a required reduction in the selling price of a product (e.g., under certain manufacturer's "buy-down" programs) have been held liable for tax on the amount received from the third party. In these transactions, the retailer receives a portion of its gross receipts from the customer in the form of a reduced payment for tangible personal property, and another portion of its gross receipts from the third party upon redemption of some type of indicia or upon fulfillment of the conditions of the third-party agreement. This approach is entirely consistent with the statutes that establish the measure of tax, namely, RTC sections 6011 and 6012. This approach is also congruent with one of the legal principles supporting the taxation of sales of wireless telecommunication devices in "bundled transactions," as set forth in Regulation 1585, *Cellular Telephones, Pagers, and Other Wireless Telecommunication Devices*, subdivision (b)(3), where the retailer receives sales revenue from both the retail customer and the service provider with whom the customer is required to contract for wireless telecommunication service.

Although the customer-knowledge approach advocated by Industry is inconsistent with staff's historic position, staff believes that Industry's approach could be viewed as a reasonable interpretation of RTC sections 6011 and 6012. It should be noted that other states that have adopted (or reaffirmed) a customer-knowledge approach pursuant to the Streamlined Sales and Use Tax Agreement have memorialized this through statutory provisions.

Reduction in the Product Selling Price: Generally, a required price reduction exists when a retailer, pursuant to a written or oral contract with another party, is required to reduce the selling price of a product from the regular selling price in order to receive additional revenue of a like amount from the other party. The price reduction can be a specific amount or a requirement not to exceed a specified reduced selling price. In staff's view, when a retailer enters into an oral or written contract with another party that requires, on a transaction-by-transaction basis, a specific reduction in the retailer's selling price of specified products in exchange for a certain payment of a like amount from the contracting party, such payments received by the retailer are part of the taxable gross receipts or sales price of the sale. Under Industry's proposal, such payments would only be subject to tax if the retail customers had knowledge of the payments through documentation given or received by the customers.

However, other promotional programs and marketing strategies exist that do not require the retailer to reduce the selling price of the product. For example, manufacturers or other third parties may base their rebate incentives on the number of units sold for a given promotional period without requiring the retailer to reduce the selling price of their products at the time of retail sale. In these types of promotional programs, the retailer may choose to reduce their selling price to promote sales in an effort

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to increase the rebate allowance paid by the third party, which is not the same as the third party requiring the retailer to reduce the selling price of the product.

Under another promotional program (e.g., a graduated rebate agreement), the third party may require the retailer to sell a certain quantity of products at a specified, reduced price for a particular period, to receive a reduction in the wholesale purchase price. Multiple thresholds, with an increase in rebate revenue for each threshold exceeded, may exist. The total amount of rebate revenue, if any, the retailer will receive is not certain at the time of retail sale. Essentially, some or all of the rebate payment is contingent on the retailer fulfilling a sales quota set by the contracting party. Under both staff's and Industry's view, when receipt of the rebate payment, or a portion of the rebate payment, is contingent and uncertain at the time of the retail sale of the specified products, the portion that is contingent and uncertain is not subject to tax. As to any portion of the rebate payment that is certain at the time of retail sale, Industry's proposal would require customer knowledge through documentation for tax to apply; staff's proposal would not require customer knowledge for tax to apply, but would require the retailer to give knowledge of the taxable rebate amount to the customer if the retailer collects tax from the customer on that amount.

Definition of a Third Party: For the past several years, staff has made a distinction, as to rebate revenue tied to specific price reductions at the time of retail sale, between: (1) retailers who receive the rebate from a vendor that sold directly to that retailer and (2) retailers who receive the rebate from a person who did not sell directly to that retailer. The latter type of transaction has been referred to as a "three-party" transaction. When a three-party transaction existed, staff considered the amounts received by the retailer from the manufacturer or other third party (i.e., a party other than the customer or the retailer's vendor), in exchange for reducing the selling price of the product, to constitute gross receipts or part of the sales price received by the retailer from the sale rather than reductions in the cost of goods sold. However, in situations where the retailer purchased directly from the manufacturer (i.e., a "two-party" transaction), staff deemed the rebate revenues received from the manufacturer as a nontaxable reduction to the cost of goods sold. Staff's prior view had the unintended consequence of giving retailers that had sufficient bargaining power to contract to purchase goods directly from manufacturers an unfair economic advantage over retailers that did not.

In other words, staff previously defined a third party as "a person other than the customer or the retailer's vendor," which is inconsistent with the concept of a third party held by interested parties. In response to the concerns raised by the interested parties regarding this inconsistency, staff has reconsidered its position regarding the definition of a third party and now recommends that the provisions of staff's version of proposed new Regulation 1671.1 define a third party as "a person other than the retailer or the retailer's customer, such as a manufacturer or retailer's vendor." In short, staff's definition of a third party now mirrors exactly that proposed by interested parties. Accordingly, under both staff's and Industry's proposals, all retailers will be treated consistently with respect to the taxability of rebate revenue.

Customer Knowledge: For purposes of the alternatives presently under consideration, customer knowledge of the rebate exists when it can be demonstrated that the customer knew, through documentation given or received by the customer at the time of retail sale, that the retailer would receive reimbursement from another party as compensation for a reduction in the selling price (or in the amount of the selling price the customer was required to pay). Specifically, customer knowledge exists when the customer presents some type of documentation (e.g., paper coupon, sticker, certificate, or electronic coupon) to the retailer to obtain a discount on the selling price *or* the documentation provided to the customer (e.g., cash register receipt or invoice) at the time of sale indicates there is a discount or price

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reduction funded by someone other than the retailer. For purpose of this discussion, this type of direct customer knowledge is referred to as knowledge through documentation.

Under Industry's version of proposed new Regulation 1671.1 (Exhibit 3), the customer knowledge provisions are satisfied only when the customer presents "documentation" to the retailer to obtain the price reduction *or* the "documentation" presented to the customer at the time of sale indicates there is a price reduction funded by someone other than the retailer. Constructive knowledge (e.g., knowledge through signs, displays, advertisements, etc.) does not suffice to establish knowledge through documentation. The proposed new regulation defines "documentation" as follows:

Documentation means a written representation or other written notification that third-party consideration has been or will be provided to the retailer. Examples of "documentation" include, but are not limited to, contracts, sales invoices, manufacturer or vendor coupons, gift certificates, customer receipts, and assignments of rebates. The written representation may be on paper or through electronic or any other means.

Documentation does not mean signage, display tags, advertisement in a newspaper or other materials, flyers, promotional materials, statements on the customer's receipt such as "you saved \$18 today," or other such general written representations. Written representations of this type do not directly notify the customer of the third-party compensation that will be provided to the retailer to compensate for the reduction in the amount the customer is required to pay.

Thus, under Industry's proposed customer knowledge provisions, when a retail price reduction is required, reimbursement or payments received by retailers under a third-party rebate program would be taxable only when the customer gives or receives documentation reflecting a reduction in selling price that is funded by someone other than the retailer (i.e., in much the same manner as manufacturer coupon transactions). It appears reasonable to assume that retailers typically will only provide documentation (e.g., a receipt noting a discount funded by a third party) to a customer to indicate a price reduction when the customer has presented documentation (e.g., a coupon) to the retailer. Documentation provided to the customer to indicate a taxable rebate payment without the customer also presenting documentation to obtain the discount would appear to exist only in a limited number of transaction types (e.g., customer assignments of manufacturer rebates to automobile dealers).

Industry Submissions: Following the second interested parties meeting held on September 19, 2006, staff received submissions from the following parties: Ms. Kristin Power, California Grocers Association, Mr. Bill Dombrowski, California Retailers Association, Mr. Michael D. Wang, Western States Petroleum Association, and Mr. Ned Roscoe. Staff also received a letter of support for Industry's proposal from Ms. Kyla Christoffersen, California Chamber of Commerce.

California Grocers Association (CGA) – In their September 27, 2006 submission, the CGA reiterates its concerns regarding the current discrepancy in staff's treatment of two-party and three-party transactions. The CGA emphasizes its support of staff's proposed change to the definition of a third party to mirror that previously proposed by interested parties. As discussed during the September 19, 2006 interested parties meeting, staff recommends that proposed new Regulation 1671.1 define a third party as "a person other than the retailer or the retailer's customer, such as a manufacturer or retailer's vendor." This definition is reflected in staff's version of proposed new Regulation 1671.1 (Exhibit 2) and is the same as Industry's proposed definition.

The CGA also emphasizes its belief that "customer knowledge" should be fundamental to any application of sales tax to rebate revenue. Moreover, the CGA observes that taxing third-party rebates

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without customer knowledge of the rebate results in tax reimbursement being collected on a price the customer has no way to verify and has not agreed to pay. The CGA believes that customer knowledge of a third-party rebate is equivalent to the customer presenting the retailer with a manufacturer coupon.

In addition to suggesting minor, nonsubstantive revisions to Industry's previously proposed Regulation 1671.1, which are included in the proposed language attached as Exhibit 3, the CGA also suggests that staff's and/or Industry's versions of Regulation 1671.1 contain two additional examples to illustrate the application of tax to purchase discounts and graduated rebate programs, respectively. After further discussion with Industry (inclusive of the CGA), staff and Industry have agreed the following clarifying examples should be added to staff's proposal (Exhibit 2, proposed subdivision (d), subparagraphs (4)(E) and (2)(E), respectively):

Example 1: Purchase Rebates vs. Sales Rebates

A retailer buys products from either a wholesaler or the manufacturer of products. Retail sales of these products are generally subject to tax. The product manufacturer and/or the wholesaler enters into an agreement with the retailer for a rebate, based upon the number of products the retailer purchases from either the manufacturer or the wholesaler, if the retailer agrees to sell the products at a "target" price for a specified period. Typically, a target price is used to establish a general price range for a particular geographic area or demographic market. The rebates received either directly from the manufacturer or from the wholesaler are not subject to tax since they are tied to the retailer's wholesale purchases of the products, not to the number of retail sales made at the target price.

Example 2: Graduated or Total Volume Sold Rebate Programs

A cola distributor enters into graduated rebate agreements with retailers that entitle the retailers to reimbursement from the distributor based on the number of 12-packs of cola the retailers sell at a required discounted price during the month of July. The amount of the sales discount is dictated by the distributor as follows. A participating retailer is certain to receive 50 cents for every 12-pack of cola the retailer sells in July at the required discounted price. However, after surpassing a minimum threshold of 12-pack units sold, the retailer will receive an additional 50 cents for each additional 12-pack sold over the threshold minimum. At the end of the promotional period, after verifying the number of 12-pack units sold, the distributor issues a rebate check to the participating retailer. Only the certain payment of 50 cents for every 12-pack of cola the retailer sells in July at the required discounted price is subject to tax. To the extent the retailer receives additional rebates for exceeding the minimum threshold, such contingent rebates are not subject to tax.

Industry's version also includes Examples 1 and 2 (Exhibit 3, proposed subdivision (d), subparagraphs (4)(E) and (2)(E), respectively), with additional detail regarding customer knowledge, to illustrate nontaxable purchase discounts. In sum, both staff and Industry agree that Example 1 represents a nontaxable purchase discount, not taxable rebate revenue and, as illustrated by Example 2, graduated rebate programs in which the amount of the rebate is *uncertain* at the time of retail sale are not subject to tax.

California Retailers Association (CRA) – In its September 29, 2006 submission, the CRA echoes the comments made by the CGA. In addition, the CRA asks for clarification of staff and Industry's jointly proposed regulatory definition of manufacturer coupons. The CRA explains that some retailers have expressed concern over the proposed regulatory language because they felt it did not differentiate clearly enough between manufacturer coupons and manufacturer-funded coupons (i.e., coupons only

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redeemable at a specific retailer, but partially or totally funded “behind the scenes” by the manufacturer). The CRA believes the coupon value should not be included in the measure of tax unless the coupon presented to the retailer clearly states that the retailer will be reimbursed by the manufacturer for the coupon value (e.g., the coupon contains the statement “manufacturer coupon” or retailer reimbursement terms are stated on the coupon).

The CRA believes that without such clarification, non-portable third-party-funded coupons that do not meet the definition of a manufacturer coupon may erroneously receive a tax treatment that does not harmonize with certain Financial Accounting Standards Board (FASB) revenue recognition guidelines.¹ The CRA recommends that any form of payment or reimbursement received by the retailer from the manufacturer and not identified as such to the customer should be treated as a reduction in the retailer’s cost of goods sold. This would include grocery store discount cards and store coupons usable at a single retail business regardless of reimbursement unless identified as a manufacturer coupon.

Based on CRA’s comments, Industry and staff agree to a revised definition of “manufacturer coupon” as follows:

MANUFACTURER COUPONS are paper or paperless coupons funded by the manufacturer that customers can utilize at the time of purchasing the manufacturer’s product, thus entitling customers to a certain amount or percentage off the advertised selling price. These coupons are generally identified as “manufacturer coupons” and include retailer reimbursement terms that must be followed by retailers in order to redeem the coupons. Amounts paid by a manufacturer to a retailer to reimburse the retailer for the value of the manufacturer coupon are included in the retailer’s gross receipts. The retailer may, by contract, charge the customer sales tax reimbursement on the amount paid by the manufacturer. When a retailer charges such reimbursement, the amount on which the reimbursement is charged is fully disclosed to the customer through the customer’s utilization of the manufacturer’s coupon.

This definition is reflected in the staff and Industry versions of proposed new Regulation 1671.1, attached as Exhibit 2 and Exhibit 3, respectively. The CRA has agreed that, with the clarification provided by this revised definition, retailers will be able to structure their rebate transactions in such a way as to harmonize California’s sales and use tax reporting requirements with the relevant FASB revenue recognition guidelines under either staff’s or Industry’s versions.

Western States Petroleum Association (WSPA) – In its October 5, 2006 submission, WSPA acknowledges that staff’s version of proposed new Regulation 1671.1, which requires retailers to provide customer knowledge when they collect tax on taxable rebate amounts, may address staff’s ongoing concern regarding consumer confusion over the taxable measure associated with rebate revenue and the collection of tax. This concern is generally based on retailers not having adequately disclosed that a third party was offering an incentive that, while reducing the out-of-pocket cost to the consumer, did not reduce the tax base. However, WSPA does not believe staff’s proposal will end all such confusion. Rather, WSPA believes Industry’s proposal better addresses this concern.

WSPA does support, however, staff’s recommendation to include examples to assist taxpayers and auditors in understanding what would be required to rebut the presumption that rebate revenue is subject to tax until the contrary is established. As illustrated in Exhibit 2, staff has included in its proposal a nonexhaustive list of examples of documentary evidence that would suffice to rebut the presumption. Based on these examples, staff does not believe it would be unduly burdensome for retailers to rebut the

¹ Emerging Issues Task Force (EITF) position on proper reporting of “Sales Incentives Offered to Consumers by Manufacturers,” EITF Abstract Issue No. 03-10.

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presumption in circumstances where the rebate revenue is, in fact, nontaxable. As does the CRA, WSPA also recommends the inclusion of Examples 1 and 2 initially proposed by the CGA.

Mr. Ned Roscoe (Mr. Roscoe) – In his September 29, 2006 submission, Mr. Roscoe recommends revisions to staff’s version of proposed new Regulation 1671.1. He believes that a reconciliation of rebate revenues received by retailers to the retailers’ purchases will support the nontaxable nature of the revenues. With Industry’s concurrence, the jointly proposed subdivision (b)(2) pertaining to purchase discounts has been revised to incorporate staff’s understanding of Mr. Roscoe’s suggested changes. The revised definition of “purchase discounts,” included in both staff’s and Industry’s versions, provides as follows:

PURCHASE DISCOUNTS are given by a manufacturer and/or wholesaler to a vendor (i.e., a retailer) based upon the amount of prior or future purchases by that vendor. These discounts are regarded as trade discounts and are excluded from gross receipts as they are based on the number of products the retailer purchased from the manufacturer and/or wholesaler and not the number of products sold by the vendor at retail. Agreements wherein the retailer agrees to sell the products at a target price for a period of time are also “purchase discounts” and excluded from gross receipts when the discount is based on the number of products purchased by the vendor. [Even if customer knowledge through documentation were present], the rebates received either directly from the manufacturer or from the wholesaler are not subject to tax since they are tied to the retailer's wholesale purchases of the products, not to the number of retail sales made at the target price. (The bracketed language is inapplicable to staff’s version.)

The inclusion of Example 1, initially proposed by the CGA, in both staff’s and Industry’s versions also appears to be responsive to Mr. Roscoe’s concerns.

VI. Alternative 1 - Staff Recommendation

A. Description of the Staff Recommendation

Staff recommends adopting its version of proposed new Regulation 1671.1 (attached as Exhibit 2) to reflect a modification to staff’s current approach to the application of tax to third-party rebates. Because of this proposed change in staff’s interpretation of third-party rebates, staff recommends that the relevant provisions of staff’s proposal that differ from Industry’s proposal be promulgated to have an operative date of October 1, 2007. Since it appears there may have been confusion among taxpayers with regard to staff’s prior interpretation, staff makes this operative date recommendation with the awareness that, if promulgated, this operative date could result in the Board granting pending petitions for redetermination and claims for refund that arose from staff’s prior interpretation. Staff’s current proposal would provide clear guidance to taxpayers on a going forward basis.

As reflected in staff’s version of proposed new Regulation 1671.1 (Exhibit 2) staff’s recommended approach to the application of tax to third-party rebates regards a retailer’s rebate income as part of the retailer’s gross receipts (or sales price when use tax applies) when the rebate program is between the retailer and a party other than the customer (i.e., a third party) *and* the rebate payment is received by the retailer in exchange for a required reduction in the retailer’s selling price of particular products on a transaction-by-transaction basis. Under such circumstances, the retailer receives payment for the sale of the product from two separate sources, the customer and the third party. When the retailer is *not* required to reduce the selling price at the time of retail sale as a condition of receiving the third-party

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rebate, the rebate revenue is not included in the retailer's gross receipts, but represents a nontaxable purchase discount or some other nontaxable allowance.

Operative October 1, 2007, staff's proposed regulation reflects a change in staff's current definition of a "third party" to mirror that recommended by interested parties (i.e., a third party is defined as a party other than the retailer or the retailer's customer, such as a manufacturer or retailer's vendor). Staff previously defined a third party as a party other than the customer or the retailer's vendor. Staff makes this operative date recommendation to allow retailers and staff sufficient time to change policies and procedures in response to the new definition.

Staff also recommends that, operative October 1, 2007, proposed new Regulation 1671.1 contain a *rebuttable presumption* that revenue received by a retailer under a rebate or incentive program is received pursuant to an oral or written contract with a third party requiring the retailer to reduce the selling price of specified products in exchange for a certain payment of a like amount from the third party, on a transaction-by-transaction basis, until the contrary is established (proposed subdivision (c)(3)(A), Exhibit 2). Staff's proposal provides a nonexhaustive list of examples that illustrate how this presumption can be rebutted. Staff believes it will not be unduly burdensome for retailers to rebut this presumption when rebate revenue is, in fact, not subject to tax.

Further, staff recommends that proposed new Regulation 1671.1 contain a requirement that, operative October 1, 2007, when a retailer collects sales tax reimbursement (or use tax when applicable) from its customer, the retailer must disclose to the customer the amount upon which tax is collected, including the amount of any taxable discounts, rebates, or incentives offered or paid to the retailer by third parties (proposed subdivision (c)(3)(B), Exhibit 2). Staff believes this provision will effectively eliminate the primary basis for the confusion that arises when customers are unable to discern how the tax charges on their receipts have been calculated by the retailer.

As does Industry's version, staff's proposal addresses an additional broad array of coupon, rebate, and discount issues that are noncontroversial. Staff's and Industry's versions of proposed new Regulation 1671.1 include the same proposed language for the following specific areas of guidance:

- Cash discounts – discounts offered by retailers to the retailer's customers for prompt payment (proposed subdivision (b)(1)).
- Purchase discounts – discounts offered by vendors to retailers based on the volume of purchases (proposed subdivision (b)(2)).
- Ad or rack allowances – allowances offered by manufacturers to retailers to advertise or display the manufacturer's product (proposed subdivision (b)(3)).
- Retailer coupons – discount coupons offered by retailers to their customers (proposed subdivision (b)(4)).
- Manufacturer coupons – coupons offered by manufacturers to retailers' customers (proposed subdivision (b)(5)).
- Customer Rebates – rebates issued directly to customers by manufacturers (proposed subdivision (c)(2), staff's version, and (c)(1), Industry's version).

B. Pros of the Staff Recommendation

- Promulgates and improves upon current Board policy regarding the taxability of discounts, coupons, rebates, and other incentives.

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- Is consistent with interpretations of RTC sections 6011 and 6012 found in case law, Regulation 1585, and annotations involving the application of tax to rebates and incentives.
- Provides the same application of tax to third-party rebate revenues received from a manufacturer, whether the taxpayer buys direct from the manufacturer or through a separate wholesale vendor.
- Provides clear guidance for self-reporting and audit purposes.
- Requires, operative October 1, 2007, that customers have sufficient knowledge to understand how tax charges were calculated on their receipts.

C. Cons of the Staff Recommendation

- Industry disagrees with the rebate and incentive provisions of the proposed regulation that do not require customer knowledge as a prerequisite for taxation.

D. Statutory or Regulatory Change

No statutory change is required. However, staff's recommendation does require the adoption of a new regulation.

E. Administrative Impact

Staff will be required to notify taxpayers of the new regulation through an article in the Tax Information Bulletin (TIB) and distribute the adopted regulation.

F. Fiscal Impact

1. Cost Impact

There will be no additional costs. Staff will notify taxpayers of the new regulation through a TIB article. The workload associated with the publication and distribution of the TIB is considered routine. Any corresponding costs would be within the Board's existing budget.

2. Revenue Impact

No on-going revenue impact. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact

Will enhance taxpayer/customer understanding of the application of tax to discounts, coupons, rebates, and other incentives.

H. Critical Time Frames

Except as noted, the provisions of the proposed regulation represent an interpretation of existing statutes and, therefore, have no operative date; however, subparagraphs (c)(1)(C), (c)(3)(A) and (c)(3)(B) of subdivision (c), which do reflect a modification to staff's current approach, have an operative date of October 1, 2007, to allow adequate time to notify taxpayers and staff of the change. Implementation will take place 30 days following approval of the regulation by the State Office of Administrative Law.

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VII. Alternative 2 – Industry Recommendation

A. Description of the Alternative

Industry's proposed new Regulation 1671.1 (attached as Exhibit 3) changes staff's current approach to the application of tax to third-party rebates. Industry's version of proposed new Regulation 1671.1 requires that two specific conditions be satisfied before the third-party rebate payments are included in a retailer's gross receipts (or sales price when use tax applies). First, a third party (as defined) must require the retailer to reduce the selling price of specified products as a condition of receiving the third-party payment. Secondly, the customer must have knowledge ("customer knowledge through documentation") of the third-party payment. If the two conditions are not satisfied, the third-party payments are not includable in the retailer's gross receipts.

Like staff's recommendation, Industry's proposed regulatory provisions do not make a distinction between two-party and three-party transactions. As does staff's version, Industry's proposed new Regulation 1671.1 addresses a broad array of coupon, rebate, and discount issues that are noncontroversial.

As reflected in Exhibit 3, Industry's proposed language merges two of the alternative approaches presented to the Board during its March 28, 2006 meeting, with some modification: an approach inspired by the Streamlined Sales and Use Tax Agreement and an approach previously proposed by interested parties at the August 6, 2003 Board meeting. Industry's proposed language models an approach similar to the Streamlined Sales and Use Tax Agreement's definition of "sales price" in that it incorporates "knowledge of the rebate" as one of its elements.

Under Industry's version of the proposed regulation, customer knowledge through documentation is required (i.e., constructive knowledge through signage, etc. does not suffice) before rebate revenues are included in a retailer's gross receipts (or sales price when use tax applies). Industry's version includes third-party rebate revenues in gross receipts *only* when the customer presents documentation to the retailer in order to obtain a discount or when the third-party reimbursement is expressly noted in the documentation provided to the customer, thereby providing notice to the customer that the third-party reimbursement was required for the reduction in the selling price. Industry's proposed language also includes a requirement that a written or oral contract between the third party and the retailer that requires the retailer to lower the selling price of a product must exist before the third-party consideration can be taxed.

Staff agrees with Industry that constructive knowledge, as a factor for determining whether payments made by a third party to the retailer are included in the retailer's gross receipts, would present undesirable administrative and audit difficulties. If the Board adopts a regulatory provision that provides that customer knowledge is a factor in determining whether rebate or incentive payments are included in the retailers' gross receipts, staff agrees customer knowledge should be based on knowledge through documentation, as proposed by Industry. However, staff does not agree that customer knowledge of the rebate should be a factor in determining whether third-party rebates are part of a retailer's gross receipts or sales price of the sale.

B. Pros of the Alternative

- Provides the same application of tax to third-party rebate revenues received from a manufacturer, whether the taxpayer buys direct from the manufacturer or through a separate wholesale vendor.

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- Ensures that customers have sufficient knowledge to understand how tax charges were calculated on their receipts.
- Provides clear guidance for self-reporting and audit purposes.
- Represents a reasonable interpretation of RTC sections 6011 and 6012.

C. Cons of the Alternative

- Creates a new requirement of customer knowledge when determining whether third-party rebate revenue received by retailers is subject to tax.

D. Statutory or Regulatory Change

No statutory change is required; however, it should be noted that states that have adopted (or reaffirmed) a customer-knowledge approach pursuant to the Streamlined Sales and Use Tax Agreement have memorialized this adoption (or reaffirmation) through statutory, not regulatory, provisions. The adoption of a new regulation is required.

E. Administrative Impact

Staff will be required to notify taxpayers of the new interpretation of RTC section 6011 and 6012 as it relates to the application of tax to rebate revenues through an article in the TIB and distribute the adopted proposed regulation.

F. Fiscal Impact

1. Cost Impact

There will be no additional costs. Staff will notify taxpayers of the new regulation through a TIB article. The workload associated with the publication and distribution of the TIB is considered routine. Any corresponding cost would be within the Board's existing budget.

2. Revenue Impact

The impact on revenue could be a loss of \$11.6 million annually. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact

Will enhance taxpayer/customer understanding of the application of tax to discounts, coupons, rebates, and other incentives.

H. Critical Time Frames

The proposed regulation represents an interpretation of existing statutes and, therefore, has no operative date.

Prepared by: Tax Policy Division, Sales and Use Tax Department
Current as of: November 6, 2006

REVENUE ESTIMATESTATE OF CALIFORNIA
BOARD OF EQUALIZATION

**PROPOSED REGULATION 1671.1, DISCOUNTS, COUPONS, REBATES,
AND OTHER INCENTIVES****Alternative 1 – Staff Recommendation**

Staff recommends the adoption of proposed new Regulation 1671.1. Staff's version provides that rebate revenues are part of the retailer's gross receipts or sales price (when use tax applies) when: (1) the rebate program is between the retailer and a third party (i.e., someone other than the retailer's customer) and (2) receipt of the rebate is contingent upon a specified reduction in the retailer's selling price of particular products in exchange for a certain payment of a like amount from the third party. In response to concerns raised by various interested parties, staff's proposal eliminates the two-party/three-party distinction to reflect a modification to staff's current approach. Currently, rebate revenues are taxed differently depending on whether or not the retailer's rebate agreement is with the retailer's direct vendor. Staff recommends an operative date of October 1, 2007, that would only apply to the elimination of the two-party/three-party distinction, the rebuttable presumption that rebate revenue received from third parties is taxable until the contrary is established, and the requirement that retailers disclose the amount upon which tax or tax reimbursement (hereafter, collectively, tax) is collected, including any taxable discounts or rebates.

Like Alternative 2, staff's version of proposed new Regulation 1671.1 represents a joint effort by staff and interested parties to clarify the application of tax to third-party rebates and to clarify other non-controversial coupon, rebate, and discount issues.

Alternative 2 – Industry Recommendation

As supported by the California Grocers Association, California Retailers Association, California Chamber of Commerce, and Western States Petroleum Association (hereafter, collectively, Industry), adopt Industry's version of proposed new Regulation 1671.1. Industry's version regards a retailer's rebate revenue as subject to tax when the following conditions are satisfied: (1) the rebate program is between the retailer and a party other than the retailer's customer (third party), (2) receipt of the rebate is conditioned upon a specified reduction in the retailer's selling price of particular products, and (3) the customer has direct knowledge, through documentation

Revenue Estimate

given or received by the customer at the time of retail sale, of the payment by the third party to reimburse the retailer for the amount of the reduction in selling price. Although not recommended by staff, to the extent the Board approves Industry's version, staff believes the proposed approach is reasonable. Industry's proposal has no operative date and would therefore, be declarative of existing law with a retroactive impact.

Like Alternative 1, Industry's version also represents a joint effort by staff and interested parties to clarify the application of tax to third-party rebates and to clarify other non-controversial coupon, rebate, and discount issues.

Background, Methodology, and Assumptions

Alternative 1 – Staff Recommendation

There is nothing in staff's proposed Regulation 1671.1 that would impact current revenues. The proposed regulation makes clear the application of tax on third-party rebate programs where the rebate program is between the retailer and a third party (i.e., someone other than the retailer's customer) and receipt of the rebate is contingent upon a specified reduction in the retailer's selling price of particular products in exchange for a certain payment of a like amount from the third party. To the extent the Board were to view the prospective operative date provided in staff's proposal as providing a basis for granting pre-existing claims, a result that staff believes would be a reasonable interpretation of staff's proposal, there would be a one-time loss of \$4.2 million in tax, if such an amount is even collectible.

Alternative 2 – Industry Recommendation

Industry's version regards a retailer's rebate revenue to be subject to tax when (1) the rebate program is between the retailer and a party other than the retailer's customer (third party), (2) receipt of the rebate is conditioned upon a specified reduction in the retailer's selling price of particular products, and (3) the customer has direct knowledge, through documentation given or received by the customer at the time of retail sale, of the payment by the third party to reimburse the retailer for the amount of the reduction in selling price. However, industry's customer knowledge criterion differs from staff recommendation which does not require the customer's knowledge of third-party participation in the sales transaction as a condition for taxability.

The customer knowledge provision of Alternative 2 would have a revenue impact on third party scanback and buy-down rebate programs that normally do not provide for the customer having knowledge of a third party participating in the sales transaction. These types of programs are prevalent among cigarette and tobacco manufacturers. In a revenue estimate prepared in July 2003 for a similar proposed change in regulation, we estimated the disbursements of scanback and buy-down rebates to California retailers amounted to \$146.7 million in cigarette and tobacco product sales. The sales and use tax on these sales amount to \$11.6 million (\$146.7 million x 7.93%) in state and local revenue.

In addition, Industry's version would not have an operative date. Therefore, the proposed regulation would allow the provisions to apply to petitions for redetermination filed, but not yet final on or after the first day of the quarter commencing after the regulation is approved by the Office of Administrative Law, and to claims for refund filed, but not yet final. There are a

Revenue Estimate

number of such petitions and claims, primarily cigarette rebates, which amount to \$4.2 million in tax; however, significant collection issues are involved. Assuming such amount is still collectible, this would be a one-time revenue loss.

Revenue Summary

Alternative 1 – Staff’s recommendation does not have an on-going revenue impact.

Alternative 2 – Industry’s proposal would have the following revenue impact.

	On-Going Revenue Loss
State (5.0%)	7,300,000
Fiscal recovery fund (0.25%)	400,000
Local (2.0%)	2,900,000
Special District (0.68%)	1,000,000
	<u>11,600,000</u>
	One-Time Revenue Loss
State (5.0%)	2,600,000
Fiscal recovery fund (0.25%)	100,000
Local (2.0%)	1,100,000
Special District (0.68%)	400,000
	<u>4,200,000</u>

Preparation

Mr. Bill Benson, Jr., Research and Statistics Section, Legislative and Research Division, prepared this revenue estimate. Mr. Dave Hayes, Manager, Research and Statistics Section, Legislative and Research Division, and Mr. Jeff McGuire, Tax Policy Manager, Sales and Use Tax Department, reviewed this revenue estimate. For additional information, please contact Mr. Benson at (916) 445-0840.

Current as of November 6, 2006.

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Proposed Regulation 1671.1. DISCOUNTS, COUPONS, REBATES, AND OTHER INCENTIVES.

References: Sections 6011, 6012, Revenue and Taxation Code
Gifts, Marketing Aids, Premiums and Prizes generally, see Regulation 1670
Trading Stamps and Related Promotional Plans generally, see Regulation 1671
Receipts for Tax Paid to Retailers, see Regulation 1686
Reimbursement for Sales Tax, see Regulation 1700

(a) IN GENERAL. Retailers often engage in marketing and sales programs in which they issue coupons or other indicia to their customers that entitle the customers to a reduction in the amount they are required to pay for products sold by the retailers. Manufacturers, vendors, and other third parties often engage in various programs that result in credits or payments made to retailers with respect to a retailer's taxable sale of products to an end-use customer. These payments and credits include, but are not limited to, purchase and cash discounts, coupon reimbursements, ad or rack allowances, buy-downs, scanbacks, voluntary price reductions and other incentives, promotions, and rebates. Under certain conditions, payments received by the retailer in the form of rebates or other types of payments or credits for products sold at retail are included in the retailer's gross receipts or sales price from the sale of the product.

(b) DISCOUNTS.

(1) CASH DISCOUNTS are offered by a retailer to its customer for prompt payment by that customer. If the customer makes prompt payment and takes the discount, the retailer's gross receipts are reduced by the amount of the discount. Cash discounts allowed and taken on sales are excluded from gross receipts. If, however, the customer does not make prompt payment, the retailer's gross receipts are the amount billed. Generally, discounts provided to customers utilizing a grocery store discount club card are regarded as cash discounts or retailer coupons.

(2) PURCHASE DISCOUNTS are given by a manufacturer and/or wholesaler to a vendor (i.e., a retailer) based upon the amount of prior or future purchases by that vendor. These discounts are regarded as trade discounts and are excluded from gross receipts as they are based on the number of products the retailer purchased from the manufacturer and/or wholesaler and not the number of products sold by the vendor at retail. Agreements wherein the retailer agrees to sell the products at a target price for a period of time are also "purchase discounts" and excluded from gross receipts when the discount is based on the number of products purchased by the vendor. The rebates received either directly from the manufacturer or from the wholesaler are not subject to tax since they are tied to the retailer's wholesale purchases of the products, not to the number of retail sales made at the target price.

(3) AD OR RACK ALLOWANCES are contractual agreements usually between a manufacturer and the retailer to advertise a product, or to give that product preferential shelf space. Ad or rack allowances are also known as "Local Pay," "Display Shelf Payments," or something similar. Such allowances are not related to the retail sale of the underlying product and are excluded from gross receipts. Generally, payments to a grocery store retailer pursuant to discounts offered through a grocery store discount club card are regarded as ad or rack allowances.

(4) RETAILER COUPONS are issued by a retailer in paper or paperless form. When presented to the retailer by the customer, they entitle the customer to buy tangible personal property at a certain amount or percentage off the advertised selling price. Although the coupons are presented to the retailer to receive a reduction in the selling price, retailer coupons do not result in compensation from a third party. If the customer has not paid any consideration for the coupon, e.g., a coupon clipped from a magazine or newspaper, the coupon represents a true price reduction resulting in a corresponding reduction in the retailer's gross receipts from the sale. If, however, the customer has previously given compensation to the retailer for the coupon, e.g., the coupon was purchased as part of a coupon booklet

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sold by the retailer to the customer, the pro rata share of the cost of the booklet represented by the purchase for which the coupon was given must be included in gross receipts.

(5) MANUFACTURER COUPONS are paper or paperless coupons funded by the manufacturer that customers can utilize at the time of purchasing the manufacturer's product, thus entitling customers to a certain amount or percentage off the advertised selling price. These coupons are generally identified as "manufacturer coupons" and include retailer reimbursement terms that must be followed by retailers in order to redeem the coupons. Amounts paid by a manufacturer to a retailer to reimburse the retailer for the value of the manufacturer coupon are included in the retailer's gross receipts. The retailer may, by contract, charge the customer sales tax reimbursement on the amount paid by the manufacturer. When a retailer charges such reimbursement, the amount on which the reimbursement is charged is fully disclosed to the customer through the customer's utilization of the manufacturer coupon.

(c) REBATES AND INCENTIVES.

(1) DEFINITIONS. For purposes of this subdivision only, the following definitions shall apply:

(A) "Discount" means a reduction in the amount of consideration the customer is required to provide in order to purchase the tangible personal property from a retailer as a result of third-party consideration promised to or received by the retailer.

(B) "Retailer's vendor" means a person who sells tangible personal property for resale directly to the retailer.

(C) Operative October 1, 2007, "third party" means a person other than the retailer or the retailer's customer, such as a manufacturer or retailer's vendor.

(2) REBATES ISSUED DIRECTLY TO CUSTOMERS. Manufacturers engage in promotional programs in which they offer product rebates directly to the retailer's customers following their purchase of the manufacturer's products. To receive the product rebate, customers are generally required to submit a rebate application form along with any required documentation (e.g., sales receipt) to the manufacturer or manufacturer's representative directly or through the retailer. Once the rebate form and required documents are processed and accepted, the manufacturer or the manufacturer's representative will issue the customer a rebate check. Rebates checks issued by manufacturers directly to the retailer's customers are not part of the retailer's gross receipts. In this situation, the customer pays the retailer the full selling price and receives a subsequent rebate directly from the manufacturer.

(3) REBATES AND INCENTIVES ISSUED TO RETAILERS. Retailers engage in rebate and incentive programs with manufacturers or other third parties that result in additional revenue for the retailer when certain conditions are satisfied. These are transactions involving buy-down programs, markdowns, discounts, coupons, rebates, and other price reductions. These rebate and incentive programs are also known as "Buy-Down Rebates," "Voluntary Price Reductions" "Promotions," "Flex" (Flex Extensions), "Coupon Redemptions," "Scanbacks," "Instant Rebates," or by a similar name.

(A) Operative October 1, 2007, when a retailer enters into an oral or written contract with a manufacturer or other third party that requires, on a transaction-by-transaction basis, a specific reduction in the retailer's selling price of specified products in exchange for a certain payment of a like amount from the contracting party (e.g., a payment that is not contingent upon selling a particular amount of the specified products), such payments received by the retailer are part of the taxable gross receipts or sales price of the sales. For purposes of this subdivision, it is rebuttably presumed that any consideration received by retailers from third parties related to promotions for sales of specified products is subject to tax until the contrary is established. The types of documentation that will generally rebut this presumption include, but are not limited to, the following:

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1. A copy of an agreement or contract between the retailer and a third party that requires the retailer to give specified products preferential shelf space or to display the products in specific areas of the retailer's establishment in exchange for the payment received.

2. A copy of an agreement or contract between the retailer and a third party that provides the retailer with an advertising allowance, equal to or in excess of the payment received, when the retailer advertises the third-party's products.

3. A copy of an agreement or contract between the retailer and a third party that provides that the retailer will only receive the payment if the retailer sells a certain quantity of the products within a specified price range during a particular period, or if the retailer purchases a certain quantity of the products during a particular period.

4. In the absence of a written agreement or contract, the retailer may use any verifiable method of establishing that the consideration received from the third party was not subject to tax, such as a signed and dated letter or other type of documentation provided by the third party, subsequent to the contract or agreement, verifying that the payment received was not paid pursuant to a contract requiring a reduction in the selling price of specified products on a transaction-by-transaction basis.

(B) Operative October 1, 2007, for purposes of this subdivision, when a retailer contracts with its customer for the addition of sales tax reimbursement to the gross receipts of tangible personal property sold at retail, or when a retailer is obligated to collect use tax measured by the sales price, the retailer is required to disclose to the customer the amount upon which sales tax reimbursement or use tax is collected, including the amount of any taxable discounts, rebates, or incentives offered or paid to the retailer by third parties. The retailer may show the amount upon which sales tax reimbursement or use tax is collected on the customer's sales receipt, sales invoice, or other proof of sale. When applicable, the retailer may also post on its premises in a location visible to the customer, or in an advertisement or other printed material directed to customers, a notice to the effect that "tax" will be added to the selling price of all items, including the amount of any taxable discounts, rebates, or incentives offered or paid to the retailer by third parties.

A retailer that does not disclose the amount of any taxable discounts, rebates, or incentives upon which sales tax reimbursement is collected, is in violation of the provisions of Regulation 1700, *Reimbursement for Sales Tax*. A retailer obligated to collect the use tax that does not disclose the amount of any taxable discounts, rebates, or incentives is in violation of the provisions of Regulation 1686, *Receipts for Tax Paid to Retailers*.

(d) EXAMPLES.

(1) The following are examples of transactions where the value of the coupon or discount is part of the retailer's gross receipts (or sales price if subject to use tax) from the sale of the product:

(A) Customer clips a coupon out of a newspaper and presents it to the retailer at the time of sale to receive a discounted price on the product purchased. The coupon indicates "Manufacturer Coupon." Since the manufacturer will compensate the retailer for the amount of the price reduction and the customer presents a manufacturer coupon to the retailer, the value of the coupon is included in the retailer's gross receipts.

(B) Coupon on dog food bag indicates \$2 off at register. The coupon also indicates "payable by Big Bad Dog Food Co. (BBDF Co.);" or "All promotional costs paid by BBDF Co." The store clerk removes the coupon from the dog food bag and enters the amount of the discount into the register. The discount is included in the retailer's gross receipts.

(C) Retailer provides its customers with a coupon discount booklet containing coupons accepted by the retailer during sales periods. The booklet includes coupons identified as "manufacturer coupons" and retailer coupons. Customers remove the coupons from the booklet and present them to the check-

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out clerk. The value of the coupons identified as “manufacturer coupons” is included in the retailer’s gross receipts. The value of the retailer coupons, however, would generally not be included in the retailer’s gross receipts.

(2) The following are examples of transactions where rebate or incentive payments are part of the retailer’s gross receipts (or sales price if subject to use tax) from the sale of the product:

(A) The retailer purchases dog food from a distributor, a separate legal entity from the manufacturer (BBDF Co.). No coupon is present on the dog food bag. However, a display notice indicates that a \$2 “price reduction is made possible by BBDF Co.” Since the retailer agrees to reduce the selling price of the product in exchange for an offsetting reimbursement from the distributor, the discounted amount is included in the retailer’s gross receipts.

(B) The retailer maintains an online sales Web site. The retailer enters into buy-down programs with manufacturers in which the manufacturers require the retailer to offer their products at a reduced price. When the customer purchases a discounted product, the customer’s invoice lists the selling price less the amount of the manufacturer’s discount. The amount of the discount is subject to tax.

(C) Retailer offers a grocery store discount club card. The customer uses the club card when purchasing various products. The customer also presents manufacturer coupons to the store clerk that are scanned along with the club card. Although the price reductions associated with the club card are not part of the retailer’s gross receipts, the value of the manufacturer coupons is included in gross receipts.

(D) Retailer purchases cosmetic products directly from the manufacturer. The manufacturer and retailer enter into a buy-down program in which the retailer is required to reduce the selling price of the manufacturer’s products. In turn, the manufacturer agrees to compensate the retailer for the amount of the price reduction. The rebate revenue is included in the retailer’s gross receipts.

(E) A cola distributor enters into graduated rebate agreements with retailers that entitle the retailers to reimbursement from the distributor based on the number of 12-packs of cola the retailers sell at a required discounted price during the month of July. The amount of the sales discount is dictated by the distributor as follows. A participating retailer is certain to receive 50 cents for every 12-pack of cola the retailer sells in July at the required discounted price. However, after surpassing a minimum threshold of 12-pack units sold, the retailer will receive an additional 50 cents for each additional 12-pack sold over the threshold minimum. At the end of the promotional period, after verifying the number of 12-pack units sold, the distributor issues a rebate check to the participating retailer. Only the certain payment of 50 cents for every 12-pack of cola the retailer sells in July at the required discounted price is subject to tax. To the extent the retailer receives additional rebates for exceeding the minimum threshold, such contingent rebates are not subject to tax.

(3) The following are examples of transactions where the value of the coupon or discount is not included in the retailer’s gross receipts (or sales price if subject to use tax) from the sale of the product:

(A) Retailer has store discount coupons printed in newspaper advertisements. The customers present the coupons when purchasing the advertised products. The retailer’s coupon is not a third-party coupon, nor is the retailer reimbursed for the amount of the discount. Although the customers may present a coupon to the retailer, the amount of the discount is not included in the retailer’s gross receipts.

(B) Retailer advertises a special promotional sale to a specific customer base. Qualifying customers are mailed a 25% discount coupon they may use on the last Tuesday of the month. The customers are required to bring the coupon to the store during the promotional period in order to receive a discount on their purchases. The retailer is not reimbursed by a third party for the discounted amount. The discounts provided to the retailer’s customers qualify as nontaxable discounts.

(C) Retailer offers a “double discount” for certain manufacturer coupons used by customers. The customers present a manufacturer coupon offering \$1 off the purchase of a specific healthcare product.

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In turn, the retailer also allows an additional \$1 off the selling price of the healthcare product. Although the value of the reimbursable manufacturer coupon is included in the amount subject to tax, the retailer's additional \$1 discount qualifies as a nontaxable discount.

(4) The following are examples of transactions where rebate and incentive payments are not included in the retailer's gross receipts (or sales price if subject to use tax) from the sale of the product:

(A) A cola distributor enters into written agreements with retailers that entitle the retailers to compensation from the distributor based on the number of 12-packs of cola the retailers sell during the month of July. The retailers retain copies of the agreements. The retailers may or may not reduce the selling price of the 12-packs. At the end of the promotional period, the distributor issues rebate checks to the participating retailers. Given the retailers can document there was no requirement to reduce the selling price of the product, the additional revenue is not included in the retailers' gross receipts.

(B) A manufacturer enters into written agreements with retailers to advertise the manufacturer's products and to provide the products preferential shelf space. Retailers that agree to the manufacturer's terms receive compensation from the manufacturer at the end of the promotional period. Assuming the retailers can document that the agreements were not based on a selling price reduction, the payments from the manufacturer are not included in the retailers' gross receipts.

(C) A retailer's vendor agrees to discount the retailer's November purchases of Christmas products by 20% if the retailer's total sales for October exceed a specific amount. The retailer increases its purchases during October, gives the products preferential shelf space and advertises the products at 10% off. Although the retailer reduced the selling price of the products, a price reduction was not a condition of the agreement. The retailer retains documentation to support this fact. The discount is a reduction to the retailer's cost of good sold, not additional gross receipts.

(D) A manufacturer's representative enters into an agreement with a retailer that entitles the retailer to compensation from the manufacturer if the retailer's sales of the manufacturer's hair and skin care products exceed a specific amount during the month of June. The retailer offers the products at a reduced price and provides the hair care products with preferential shelf space. The retailer's sales for June exceed the specified amount and the manufacturer issues a check to the retailer, as agreed. The rebate payment is not subject to tax.

(E) A retailer buys products from either a wholesaler or the manufacturer of products. Retail sales of these products are generally subject to tax. The product manufacturer and/or the wholesaler enters into an agreement with the retailer for a rebate, based upon the number of products the retailer purchases from either the manufacturer or the wholesaler, if the retailer agrees to sell the products at a "target" price for a specified period. Typically, a target price is used to establish a general price range for a particular geographic area or demographic market. The rebates received either directly from the manufacturer or from the wholesaler are not subject to tax since they are tied to the retailer's wholesale purchases of the products, not to the number of retail sales made at the target price.

(F) During a routine audit of the retailer's books and records, the retailer is asked to provide documentation to support its nontaxable treatment of the revenue received; however, the retailer does not have sufficient documentation to support its reporting of the transactions in question. To verify that the revenue received from the manufacturer was not part of gross receipts, the retailer sends a letter to the manufacturer requesting that the manufacturer verify that the payment received under their promotional agreement was not paid pursuant to a contract requiring the retailer to reduce the selling price of their products. The manufacturer signs and dates the letter verifying this fact and returns it to the retailer. No concerns regarding the authenticity of the letter exist. Since the subsequent verification establishes that the rebate revenue was not paid in exchange for a required reduction to the retailer's selling price of the manufacturer's products, the revenue is not part of the retailer's gross receipts.

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(5) The following are examples of transactions involving payments by automobile manufacturers to automobile dealers or end-use customers with respect to the sale or lease of automobiles.

(A) An automobile manufacturer provides a customer with a \$1,000 rebate upon the purchase of a specific automobile. Rather than receive payment from the manufacturer, the customer assigns the rebate to the dealer, who in turn applies the amount of that rebate toward the customer's payment for the vehicle. The \$1,000 payment by the manufacturer is part of the dealer's gross receipts, since the rebate is provided to the customer who uses the rebate amount to partially satisfy that customer's total payment obligation to the dealer. The \$1,000 rebate does not constitute a reduction in the retailer's gross receipts as a retailer's coupon, cash discount, purchase discount, or otherwise.

(B) An automobile dealer receives a \$500 incentive from the automobile manufacturer for every vehicle sold of a specific model in a given period. The manufacturer does not have an oral or written contract requiring the dealer to sell the specific model at a reduced price. The selling price is based solely on the dealer's discretion. Under these facts, the \$500 payment by the manufacturer is not part of the dealer's gross receipts since the manufacturer does not require a reduction in the retail selling price of the vehicle. The \$500 incentive instead constitutes a reduction in the dealer's cost of goods sold.

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Proposed Regulation 1671.1. DISCOUNTS, COUPONS, REBATES, AND OTHER INCENTIVES.

References: Sections 6011, 6012, Revenue and Taxation Code
 Gifts, Marketing Aids, Premiums and Prizes generally, see Regulation 1670
 Trading Stamps and Related Promotional Plans generally, see Regulation 1671
 Reimbursement for Sales Tax, see Regulation 1700

(a) IN GENERAL. Retailers often engage in marketing and sales programs in which they issue coupons or other indicia to their customers that entitle the customers to a reduction in the amount they are required to pay for products sold by the retailers. Manufacturers, vendors, and other third parties often engage in various programs that result in credits or payments made to retailers with respect to a retailer's taxable sale of products to an end-use customer. These payments and credits include, but are not limited to, purchase and cash discounts, coupon reimbursements, ad or rack allowances, buy-downs, scanbacks, voluntary price reductions and other incentives, promotions, and rebates. Under certain conditions, payments received by the retailer in the form of rebates or other types of payments or credits for products sold at retail are included in the retailer's gross receipts or sales price from the sale of the product.

For purposes of this regulation, the following definitions shall apply:

(1) "DISCOUNT" means a reduction in the amount of consideration the customer is required to pay in order to purchase products from a retailer.

(2) "DOCUMENTATION" means a written representation or other written notification that third-party consideration has been or will be provided to the retailer. Examples of "documentation" include, but are not limited to, contracts, sales invoices, manufacturer or vendor coupons, gift certificates, customer receipts, and assignments of rebates. The written representation may be on paper or through electronic or any other means.

"Documentation" does not mean signage, display tags, advertisement in a newspaper or other materials, flyers, promotional materials, statements on the customer's receipt such as "you saved \$18 today," or other such general written representations. Written representations of this type do not directly notify the customer of the third-party compensation that will be provided to the retailer to compensate for the reduction in the amount the customer is required to pay.

(3) "THIRD PARTY" means a person other than the retailer or the retailer's customer, such as a manufacturer or retailer's vendor.

(b) DISCOUNTS

(1) CASH DISCOUNTS are offered by a retailer to its customer for prompt payment by that customer. If the customer makes prompt payment and takes the discount, the retailer's gross receipts are reduced by the amount of the discount. Cash discounts allowed and taken on sales are excluded from gross receipts. If, however, the customer does not make prompt payment, the retailer's gross receipts are the amount billed. Generally, discounts provided to customers utilizing a grocery store discount club card are regarded as cash discounts or retailer coupons.

(2) PURCHASE DISCOUNTS are given by a manufacturer and/or wholesaler to a vendor (i.e., a retailer) based upon the amount of prior or future purchases by that vendor. These discounts are regarded as trade discounts and are excluded from gross receipts as they are based on the number of products the retailer purchased from the manufacturer and/or wholesaler and not the number of products sold by the vendor at retail. Agreements wherein the retailer agrees to sell the products at a target price for a period of time are also "purchase discounts" and excluded from gross receipts when the discount is based on the number of products purchased by the vendor. Even if customer knowledge through documentation were present, the rebates received either directly from the manufacturer or from the

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wholesaler are not subject to tax since they are tied to the retailer's wholesale purchases of the products, not to the number of retail sales made at the target price.

(3) AD OR RACK ALLOWANCES are contractual agreements usually between a manufacturer and the retailer to advertise a product, or to give that product preferential shelf space. Ad or rack allowances are also known as "Local Pay," "Display Shelf Payments," or something similar. Such allowances are not related to the retail sale of the underlying product and are excluded from gross receipts. Generally, payments to a grocery store retailer pursuant to discounts offered through a grocery store discount club card are regarded as ad or rack allowances.

(4) RETAILER COUPONS are issued by a retailer in paper or paperless form. When presented to the retailer by the customer, they entitle the customer to buy tangible personal property at a certain amount or percentage off the advertised selling price. Although the coupons are presented to the retailer to receive a reduction in the selling price, retailer coupons do not result in compensation from a third party. If the customer has not paid any consideration for the coupon, e.g., a coupon clipped from a magazine or newspaper, the coupon represents a true price reduction resulting in a corresponding reduction in the retailer's gross receipts from the sale. If, however, the customer has previously given compensation to the retailer for the coupon, e.g., the coupon was purchased as part of a coupon booklet sold by the retailer to the customer, the pro rata share of the cost of the booklet represented by the purchase for which the coupon was given must be included in gross receipts.

(5) MANUFACTURER COUPONS are paper or paperless coupons funded by the manufacturer that customers can utilize at the time of purchasing the manufacturer's product, thus entitling customers to a certain amount or percentage off the advertised selling price. These coupons are generally identified as "manufacturer coupons" and include retailer reimbursement terms that must be followed by retailers in order to redeem the coupons. Amounts paid by a manufacturer to a retailer to reimburse the retailer for the value of the manufacturer coupon are included in the retailer's gross receipts. The retailer may, by contract, charge the customer sales tax reimbursement on the amount paid by the manufacturer. When a retailer charges such reimbursement, the amount on which the reimbursement is charged is fully disclosed to the customer through the customer's utilization of the manufacturer coupon.

(c) REBATES AND INCENTIVES

(1) REBATES ISSUED DIRECTLY TO CUSTOMERS. Manufacturers engage in promotional programs in which they offer product rebates directly to the retailer's customers following their purchase of the manufacturer's products. To receive the product rebate, customers are generally required to submit a rebate application form along with any required documentation (e.g., sales receipt) to the manufacturer or manufacturer's representative directly or through the retailer. Once the rebate form and required documents are processed and accepted, the manufacturer or the manufacturer's representative will issue the customer a rebate check. Rebates checks issued by manufacturers directly to the retailer's customers are not part of the retailer's gross receipts. In this situation, the customer pays the retailer the full selling price and receives a subsequent rebate directly from the manufacturer.

(2) REBATES AND INCENTIVES ISSUED TO RETAILERS. Retailers engage in rebate and incentive programs with manufacturers or other third parties that result in additional revenue for the retailer when certain conditions are met. These are transactions involving buy-down programs, markdowns, discounts, coupons, rebates, and other price reductions. These rebate and incentive programs are also known as "Buy-Down Rebates," "Voluntary Price Reductions" "Promotions," "Flex" (Flex Extensions), "Coupon Redemptions," "Scanbacks," "Instant Rebates" or by a similar name.

Revenue received by the retailer from these types of programs or other similar types of programs is part of the retailer's gross receipts (or sales price if subject to use tax) from the sale to a customer when both of the following conditions are met:

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(A) Receipt of the rebate or incentive revenue is conditioned upon the retailer's sale of the product at a reduced selling price. A conditional price reduction exists when the manufacturer, vendor, or other third party requires, through a written or oral contract, the retailer to reduce the retailer's selling price of the product from the regular selling price. The price reduction can be a specific amount or a requirement to not exceed a specified reduced selling price.

(B) The customer has knowledge that the manufacturer, vendor, or other third party will reimburse the retailer for the amount of the price reduction. Customer knowledge of the additional reimbursement is present when the customer presents "documentation" to the retailer to obtain the price reduction or the "documentation" presented to the customer at the time of sale indicates there is a price reduction.

Both conditions must be met for the rebate or incentive revenue to be considered part of the retailer's gross receipts. If both of the conditions are not met, the rebate or incentive revenue will not be includable in the retailer's gross receipts.

(d) EXAMPLES

(1) The following are examples of transactions where the value of the coupon or discount is part of the retailer's gross receipts (or sales price if subject to use tax) from the sale of the product:

(A) Customer clips a coupon out of the newspaper and presents it to the retailer at the time of sale to receive a discounted price on the product purchased. The coupon indicates "Manufacturer Coupon." Since the manufacturer will compensate the retailer for the amount of the price reduction and the customer presents a manufacturer coupon to the retailer, the value of the coupon is included in the retailer's gross receipts.

(B) Display aisle has a coupon dispenser above a display of cereal boxes. The dispensed coupons indicate \$1 off "Fruity Juice Cereal" - "Manufacturer Coupon." The customer presents the coupon to the retailer along with the box of cereal and is given \$1 off the product's selling price. The value of the coupon is subject to tax.

(C) Coupon on dog food bag indicates \$2 off at register. The coupon also indicates "payable by Big Bad Dog Food Co. (BBDF Co.)" or "All promotional costs paid by BBDF Co." The store clerk removes the coupon from the dog food bag and rings up the original price and the amount of the discount. The customer's sales receipt lists the \$2 discount. The amount of the discount is subject to tax.

(D) Retailer provides its customers with a coupon discount booklet containing coupons accepted by the retailer during sales periods. The booklet includes coupons identified as "manufacturer coupons" and non-identified coupons. Customers remove the coupons from the booklet and present them to the check-out clerk. The value of the coupons identified as "manufacturer coupons" is included in the retailer's gross receipts. The value of the non-identified coupons, however, would generally not be included in the retailer's gross receipts.

(2) The following are examples of transactions where rebate or incentive payments are part of the retailer's gross receipts (or sales price if subject to use tax) from the sale of the product:

(A) The retailer purchases dog food from a distributor, a separate legal entity from the manufacturer (BBDF Co.). No coupon is present on the dog food bag. However, a display notice indicates that a \$2 "price reduction is made possible by BBDF Co." The amount of \$2 is separately itemized on the customer's receipt and identified as a BBDF discount. Since the retailer agrees to reduce the selling price of the product and the customer is provided a receipt ("documentation") identifying the amount of the manufacturer's discount, the discounted amount is included in the retailer's gross receipts. If the customer's receipt did not identify the discount as a manufacturer discount, however, the required conditions would not be met. The display notice does not qualify as "documentation."

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(B) The retailer maintains an online sales Web site. The retailer enters into buy-down programs with manufacturers in which the manufacturers require the retailer to offer their products at a reduced price. When the customer purchases a discounted product, the customer's invoice lists the selling price less the amount of the manufacturer's discount. The discounted amount is identified as a "manufacturer's rebate." In addition to a receipt the customer may print, the retailer also e-mails a confirmation to the customer with a copy of the sales data and the rebate information. The discounted amount is subject to tax.

(C) Retailer offers a grocery store discount club card. The customer uses the club card when purchasing various products. The customer also presents manufacturer coupons to the store clerk that are scanned along with the club card. The customer's receipt contains the following statement: "You saved \$8 today." Although the price reductions associated with the club card are generally not part of the retailer's gross receipts, the value of the manufacturer coupons is included in gross receipts.

(D) Retailer purchases cosmetic products directly from the manufacturer. The manufacturer and retailer enter into a buy-down program in which the retailer is required to reduce the selling price of the manufacturer's products. In turn, the manufacturer agrees to compensate the retailer for the amount of the price reduction. The cosmetic packaging includes a coupon with the following statement: \$5 off courtesy of Sun Image Cosmetics. The customer presents the coupon to the clerk and is given \$5 off the regular selling price. The rebate revenue is included in the retailer's gross receipts.

(E) A cola distributor enters into graduated rebate agreements with retailers that entitle the retailers to reimbursement from the distributor based on the number of 12-packs of cola the retailers sell at a required discounted price during the month of July. The amount of the sales discount is dictated by the distributor as follows. A participating retailer is certain to receive 50 cents for every 12-pack of cola the retailer sells in July at the required discounted price. However, after surpassing a minimum threshold of 12-pack units sold, the retailer will receive an additional 50 cents for each additional 12-pack sold over the threshold minimum. At the end of the promotional period, after verifying the number of 12-pack units sold, the distributor issues a rebate check to the participating retailer. If customer knowledge through documentation is present, only the certain payment of 50 cents for every 12-pack of cola the retailer sells in July at the required discounted price is subject to tax. To the extent the retailer receives additional rebates for exceeding the minimum threshold, such contingent rebates are not subject to tax.

(3) The following are examples of transactions where the value of the coupon or discount is not included in the retailer's gross receipts (or sales price if subject to use tax) from the sale of the product:

(A) Retailer has store discount coupons printed in newspaper advertisements. The customers present the coupons when purchasing the advertised products. The retailer's coupon is not a third-party coupon, nor is the retailer reimbursed for the amount of the discount. Although the customers may present a coupon to the retailer, the amount of the discount is not included in the retailer's gross receipts.

(B) Using the example from (d)(1)(D), except in this case, the store register automatically rings up the discounted price or the store clerk scans a coupon from a packet of coupons when the customer does not present the required coupon. Although the customer's receipt shows the amount of the discount, it is not identified as a third-party discount. Thus, the amount of the discount is not included in the retailer's gross receipts. The customer did not present "documentation" to the store clerk, nor was the customer provided "documentation" at the time of sale.

(4) The following are examples of transactions where rebate and incentive payments are not included in the retailer's gross receipts (or sales price if subject to use tax) from the sale of the product:

(A) Coupon on a dog food bag says \$2 off at register. There is no indication on the coupon, on the customer's receipt, or on any other related documentation that the retailer will receive \$2 from another party to compensate for the \$2 price reduction. Whether or not the price reduction is based on an agreement with a third party to reduce the selling price of the dog food, the customer did not present or

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receive “documentation” that demonstrates the customer had knowledge of the reimbursement from a third party.

(B) A cola distributor enters into agreements with retailers that entitle the retailers to compensation from the distributor based on the number of 12-packs of cola the retailers sell during the month of July. The retailers may or may not reduce the selling price of the 12-packs. At the end of the promotional period, the distributor issues rebate checks to the participating retailers. Even if customer knowledge through documentation were present, since the retailer is not required to reduce the selling price of the product, the additional revenue is not included in the retailer's gross receipts.

(C) A manufacturer enters into agreements with retailers to advertise the manufacturer's products and to provide the products with preferential shelf space. Retailers that agree to the manufacturer's terms receive compensation from the manufacturer at the end of the promotional period. Since the agreements are not based on a selling price reduction, the payments are not included in the retailers' gross receipts.

(D) A retailer's vendor agrees to discount the retailer's November purchases of Christmas products by 20% if the retailer's total sales for October exceed a specific amount. The retailer increases its purchases during October, gives the products preferential shelf space and advertises the products at 10% off. Although the retailer reduced the selling price of the products, a price reduction was not a condition of the agreement. The purchase discount is a reduction to the retailer's cost of good sold, not additional gross receipts.

(E) A retailer buys products from either a wholesaler or the manufacturer of products. Retail sales of these products are generally subject to tax. The product manufacturer and/or the wholesaler enters into an agreement with the retailer for a rebate, based upon the number of products the retailer purchases from either the manufacturer or the wholesaler, if the retailer agrees to sell the products at a “target” price for a specified period. Typically, a target price is used to establish a general price range for a particular geographic area or demographic market. Even if customer knowledge through documentation were present, the rebates received either directly from the manufacturer or from the wholesaler are not subject to tax since they are tied to the retailer's wholesale purchases of the products, not to the number of retail sales made at the target price.

(5) The following are examples of transactions involving payments by automobile manufacturers to automobile dealers or end-use customers with respect to the sale or lease of automobiles.

(A) An automobile manufacturer provides a customer with a \$1,000 rebate upon the purchase of a specific automobile. Rather than receive payment from the manufacturer, the customer assigns the rebate to the dealer, who in turn applies the amount of that rebate toward the customer's payment for the vehicle. The \$1,000 payment by the manufacturer is part of the dealer's gross receipts, since the rebate is provided to the customer who uses the rebate amount to partially satisfy that customer's total payment obligation to the dealer. The \$1,000 rebate does not constitute a reduction in the retailer's gross receipts as a retailer's coupon, cash discount, purchase discount, or otherwise.

(B) An automobile dealer receives a \$500 incentive from the automobile manufacturer for every vehicle sold of a specific model in a given period. The manufacturer does not have an oral or written contract requiring the dealer to sell the specific model at a reduced price. The selling price is based solely on the dealer's discretion. Under these facts, the \$500 payment by the manufacturer is not part of the dealer's gross receipts since the manufacturer does not require a reduction in the retail selling price of the vehicle. The \$500 incentive instead constitutes a reduction in the dealer's cost of goods sold.